SECURITIES AND EXCHANGE COMMISSION

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

MARY JO WHITE, CHAIR

LUIS A. AGUILAR, COMMISSIONER

DANIEL M. GALLAGHER, COMMISSIONER

KARA M. STEIN, COMMISSIONER

MICHAEL S. PIWOWAR, COMMISSIONER

(9 documents)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 76561 / December 4, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16980

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| In the Matter of<br><br>Fox Energy Corp.,<br><br>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 Fox Energy Corp.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Fox Energy Corp. (CIK No. 141166) is a void Delaware corporation located in St. Joseph, Missouri with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Fox Energy Corp. 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, 2008, which reported a net loss of $3,134 from the company's January 11, 2008 inception through September 30, 2008.

B. DELINQUENT PERIODIC FILINGS

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, have repeatedly failed to meet its obligations to file timely

periodic reports, and failed to heed delinquency letters sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations or, through its failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive such letters.

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

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

This Order shall be served forthwith upon Respondent personally or by certified, registered, or Express Mail, or by other means 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.

Brent J. Fields
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. 76560 / December 4, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16979

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| In the Matter of<br><br>Ben Franklin Financial, Inc.<br>(a/k/a Franklin Ben Financial, Inc.),<br>Cincinnati Regional Initiative Inc.<br>(a/k/a Midwest Regional Authority, Inc.,<br>a/k/a Buffalo Capital II Ltd.),<br>Dayton General Systems, Inc.,<br>Display.IT Holdings PLC, and<br>Gali Global Holdings Ltd.,<br><br>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 Ben Franklin Financial, Inc. (a/k/a Franklin Ben Financial, Inc.), Cincinnati Regional Initiative Inc. (a/k/a Midwest Regional Authority, Inc., a/k/a Buffalo Capital II Ltd.), Dayton General Systems, Inc., Display.IT Holdings PLC, and Gali Global Holdings Ltd.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Ben Franklin Financial, Inc. (a/k/a Franklin Ben Financial, Inc.) ("Ben Franklin Financial") (CIK No. 1059089) is a surrendered Delaware corporation located in Arlington Heights, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Ben Franklin Financial is delinquent in its

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periodic filings with the Commission, having not filed any periodic reports since it filed a Form 8-A registration statement on May 13, 1998.

2. Cincinnati Regional Initiative Inc. (a/k/a Midwest Regional Authority, Inc., a/k/a Buffalo Capital II Ltd.) ("Cincinnati Regional") (CIK No. 1025842) is a dissolved Colorado corporation located in Cincinnati, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Cincinnati Regional Initiative is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended May 31, 1997, which reported a net loss of $63,613 for the prior nine months.

3. Dayton General Systems, Inc. ("Dayton General Systems") (CIK No. 1039774) is a Pennsylvania corporation located in Miamisburg, Ohio with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Dayton General Systems is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 1998, which reported a net loss of $145,126 for the prior three months.

4. Display.IT Holdings PLC ("Display.IT Holdings") (CIK No. 1033018) is a dissolved United Kingdom public limited company located in London, England with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Display.IT Holdings is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed its amended Form 20-F registration statement on March 27, 1997.

5. Gali Global Holdings Ltd. ("Gali Global Holdings") (CIK No. 1040856) is an Israeli corporation located in Ramat Eliyahu, Israel with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Gali Global Holdings is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 8-A registration statement on November 21, 1997.

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'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.

Brent J. Fields
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. 9989 / December 14, 2015**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76642 / December 14, 2015**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 4291 / December 14, 2015**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 31935 / December 14, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-15842**

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| **In the Matter of**<br><br>**TOTAL WEALTH MANAGEMENT, INC., JACOB KEITH COOPER, NATHAN MCNAMEE, AND DOUGLAS DAVID SHOEMAKER**<br><br>**Respondents.** | **ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO RESPONDENT TOTAL WEALTH MANAGEMENT, INC.** |

**I.**

On April 15, 2014, the Securities and Exchange Commission ("Commission") instituted proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Respondents Total Wealth Management, Inc. ("Total Wealth"), Jacob Keith Cooper, Nathan McNamee, and Douglas David Shoemaker.



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## II.

Total Wealth, through its Court-appointed Receiver Kristen Janulewicz, 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, Total Wealth consents to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, as set forth below.

## III.

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

### A. SUMMARY

1. This proceeding involves misconduct by Total Wealth, a registered investment adviser; Jacob Keith Cooper ("Cooper"), its co-founder, sole owner, and CEO; Nathan McNamee ("McNamee"), its former president and chief compliance officer; and Douglas David Shoemaker ("Shoemaker"), its co-founder and former chief compliance officer. The respondents engaged in this conduct in connection with investments made in the unregistered Altus Capital Opportunity Fund, LP ("Altus Capital Opportunity Fund") and a series of unregistered fund of funds referred to as the "Altus Portfolio Series" (collectively, with the Altus Capital Opportunity Fund, the "Altus Funds").

2. Starting in at least 2009, Total Wealth and Cooper breached their fiduciary duties to their clients and investors through a fraudulent scheme to collect, and conceal their receipt of, undisclosed revenue sharing fees derived from investments they recommended to their clients. Total Wealth, Cooper, McNamee, and Shoemaker each received undisclosed revenue sharing fees, which were funneled through entities created by the individuals to mask their receipt of the fees. In addition, Total Wealth and Cooper materially misrepresented to investors and clients the extent of the due diligence conducted on the investments they recommended. Total Wealth also violated the custody rule by failing to obtain annual audits from an independent public accountant subject to regular inspection by the Public Company Accounting Oversight Board ("PCAOB").

3. McNamee, a former investment adviser representative with Total Wealth and former registered representative, and Shoemaker, a current investment adviser representative with Total Wealth and former registered representative, aided, abetted, and caused Total Wealth's and Cooper's violations. McNamee and Shoemaker, who knew about the revenue

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

sharing arrangements and the related misrepresentations, likewise failed to fully disclose those arrangements to clients. Cooper and McNamee also aided, abetted, and caused Total Wealth's custody rule violation.

## B. RESPONDENTS

4. Total Wealth is a California corporation with its principal place of business in San Diego, California. Total Wealth registered with the Commission as an investment adviser on November 25, 2009, and as of April 2014 had approximately $90.2 million under management in 481 client accounts. Total Wealth is the owner and managing member of Altus Management and the investment adviser to the Altus Capital Opportunity Fund and the Altus Portfolio Series Funds. On February 12, 2015, Kristen Janulewicz was appointed Permanent Receiver of Total Wealth in the matter captioned *Securities and Exchange Commission v. Total Wealth Management, Inc., et al.*, Case No. 15-cv-226 BAS (DHB), pending in the United States District Court for the Southern District of California.

5. Cooper resides in Washington, Utah. He is the co-founder, sole owner, and CEO of Total Wealth. He previously held Series 6 and 63 licenses. Cooper was a registered representative and associated with three broker-dealers and another investment adviser from 2001 through 2005. He resigned from Sun America Securities, Inc. in 2005. In 2007, Sun America reported the receipt and settlement of a customer complaint that Cooper forged signatures on account application paperwork and failed to explain the difference between variable life products versus mutual fund products. Thereafter, he co-founded Total Wealth with Shoemaker.

6. McNamee resides in Haslemere, England and previously resided in Hurricane, Utah. He was an investment adviser representative with Total Wealth from 2009 to 2013. He served as Total Wealth's president beginning in early 2011 and its chief compliance officer beginning in May 2011. McNamee previously held Series 7, 63, and 66 licenses. McNamee was a registered representative of Financial Telesis, Inc., a registered broker-dealer, from December 2009 through December 2010.

7. Shoemaker resides in San Diego, California. He is the co-founder, former chief compliance officer (until 2011), and a current investment adviser representative of Total Wealth. Shoemaker holds a Series 65 license and previously held Series 6 and 63 licenses. Shoemaker was a registered representative and associated with the same broker-dealers and investment adviser as Cooper from 2001 through 2005.

## C. OTHER RELEVANT ENTITIES

8. Altus Capital Management, LLC ("Altus Management") is a Delaware limited liability corporation with its principal place of business in San Diego, California. Altus Management is the general partner to the Altus Capital Opportunity Fund and the Altus Portfolio Series. Altus Management has never registered with the Commission in any capacity and has no disciplinary history with the Commission.

9. The Altus Capital Opportunity Fund is a Delaware limited partnership and an unregistered fund of funds. It first filed a Form D on January 25, 2010 claiming exemption from

registration under Rule 506 of Regulation D of the Securities Act and an exclusion from the definition of "investment company" in Section 3(c)(1) of the Investment Company Act.

10. Altus Conservative Portfolio Series, LP, Altus Focused Growth Portfolio Series, LP, Altus Income Portfolio Series, LP, Altus Growth Portfolio Series, LP, Altus Moderate Growth Portfolio Series, LP, and Altus Moderate Portfolio Series, LP are a family of Delaware limited partnerships. They are a series of unregistered funds of funds referred to as the "Altus Portfolio Series" (collectively, the "Altus Portfolio Series Funds"). The Altus Portfolio Series Funds filed Forms D in 2011 claiming exemption from registration under Rule 506 and Section 3(c)(1) of the Investment Company Act.

11. Capita Advisors, Inc. ("Capita") is a California corporation with its principal place of business in San Diego, California. Capita purports to be a consulting company, and was founded and is operated solely by McNamee. Capita has never registered with the Commission in any capacity and has no disciplinary history with the Commission.

12. Financial Council, Inc. ("Financial Council") is a California corporation with its principal place of business in San Diego, California. Financial Council purports to be a consulting company, and was founded and is operated solely by Shoemaker. Financial Council has never registered with the Commission in any capacity and has no disciplinary history with the Commission.

13. Pinnacle Wealth Group, Inc. ("Pinnacle") is a California corporation with its principal place of business in San Diego, California. Pinnacle purports to be a consulting company, and was founded and is operated solely by Cooper. Pinnacle has never registered with the Commission in any capacity and has no disciplinary history with the Commission.

## D. FACTUAL ALLEGATIONS

### 1. Background of the Altus Funds

14. Total Wealth, which was founded by Cooper and Shoemaker, is an investment adviser to the Altus Funds. Total Wealth is also the owner and managing member of Altus Management, which is the general partner to the Altus Funds.

15. Cooper organized the Altus Capital Opportunity Fund in late 2009 in order to allow Total Wealth clients to pool their money to meet the mandatory minimum investment requirement for funds for which they otherwise might not qualify.

16. Two years later, in 2011, Cooper established the Altus Portfolio Series Funds, a series of pooled investment funds. The Altus Funds – Altus Capital Opportunity Fund and the Altus Portfolio Series Funds – invested their assets in other funds, which were selected by Cooper. The Altus Capital Opportunity Fund and the Altus Portfolio Series Funds held many of the same investments.

17. Cooper, Shoemaker, and McNamee made all of the investment decisions and recommendations for their respective Total Wealth clients, including those who invested in the Altus Funds. These clients paid for this advice based on the amount of assets that were being

managed. As the CEO and owner of Total Wealth, Cooper directly benefited from the fees Total Wealth received.

18. Total Wealth identified potential new clients through paid weekly radio broadcasts, existing client referrals, webinars, the company website, and meet-and-greets through a local speaker's bureau or a free lunch. Prior to the formation of the Altus Capital Opportunity Fund, existing Total Wealth clients could choose to place their investment funds directly in the offerings recommended by the respondents.

19. Starting in 2010, Total Wealth, Cooper, Shoemaker, and McNamee began advising their preexisting clients to transfer their individual investments to the Altus Capital Opportunity Fund. At the same time, they also began offering the Altus Capital Opportunity Fund to new Total Wealth clients and later, in 2011, they began offering the Altus Portfolio Series Funds to Total Wealth clients.

20. Cooper, McNamee, and Shoemaker met with potential investors prior to accepting them as clients of Total Wealth or as investors in the Altus Funds. As investment adviser representatives, they then prepared written investment recommendations and discussed them with their prospective clients. Total Wealth provided clients with prospective investor packets and brochures, including a packet designed specifically for prospective investors in the Altus Funds. The packet frequently included an executive summary of the fund, which was created and approved by Cooper, who solicited input from McNamee and Shoemaker. Total Wealth also provided the executive summary to potential investors who participated in its client webinars.

21. Investors in the Altus Funds typically received an offering memorandum, a limited partnership agreement, and a subscription agreement. In May 2011, when McNamee became the chief compliance officer, he "signed off" on all material provided to prospective investors. The funds' offering memoranda state that Altus Management will "adhere" to the provisions of the Investment Advisers Act. The offering memoranda also specifically state, in all capital letters, that "provisions referenced to [Altus Management] . . . may also be deemed to apply, and should be read to apply equally to [Total Wealth], and vice versa where relevant."

22. In May 2011, McNamee also assumed responsibility for verifying that all investors received the current Form ADV for Total Wealth. Shoemaker signed the firm's Forms ADV for Total Wealth in 2009 and 2010, Cooper signed the Forms ADV for Total Wealth in 2011, and McNamee signed the Forms ADV for Total Wealth thereafter.

23. Once a client invested in one of the Altus Funds, Altus Management had the discretion to buy and sell that client's holdings without notice. Total Wealth clients who invested directly in the Altus Funds typically did not receive offering documents regarding the underlying investments held by the Altus Funds. Instead, they received statements directly from the Altus Funds (via Total Wealth), and the only offering memorandum that they may have seen are those of the Altus Funds themselves. As a result, there was little to no transparency provided to investors that would allow them to evaluate the merit of the underlying holdings of the Altus Funds or whether Total Wealth possessed any relationship to those entities. As of April 2014, approximately 75% of Total Wealth's clients were invested in one or more of the Altus Funds. Likewise, approximately 75% of Total Wealth's clients were individuals.

24. As of April 2013, the Altus Capital Opportunity Fund had a gross asset value of approximately $43.5 million held for 86 beneficial owners. As of February 2013, the Altus Portfolio Series Funds collectively held gross assets of approximately $10.9 million.

### 2. Total Wealth's Revenue Sharing Fee Arrangements

25. Starting in at least February 2008, prior to the creation of the Altus Capital Opportunity Fund, Total Wealth had revenue sharing arrangements in place with several investment funds. Under these agreements, these other funds paid Total Wealth a fee when Total Wealth placed its clients' investments in those funds. Cooper signed all of the revenue sharing agreements on behalf of Total Wealth.

26. Total Wealth paid Cooper, McNamee, and Shoemaker a portion of the revenue sharing fees it received. Through written agreements signed by McNamee and Shoemaker, Total Wealth agreed to pay each person 70%-80% of the revenue sharing fees earned for every Total Wealth client he placed into the underling funds. Cooper received his revenue sharing fees without the use of a written agreement.

27. About the same time that the Altus Capital Opportunity Fund was established, Cooper formed Pinnacle, and he advised Shoemaker and McNamee to form Financial Council and Capita, respectively.

28. Pinnacle, Financial Council, and Capita (the "Side Entities") received in their bank accounts the revenue sharing fees paid to their respective owners, and these Side Entities performed virtually no consulting work. Typically, Cooper, McNamee and Shoemaker funneled their revenue sharing payments through the Side Entities. For the collection of revenue sharing fees, Cooper simply paid money directly from Total Wealth to Pinnacle. McNamee and Shoemaker issued invoices on behalf of their Side Entities, and these invoices frequently characterized the fees as something other than revenue sharing fees, concealing the true nature of the fees paid. For example, in 2010, Financial Council, Shoemaker's entity, consistently submitted invoices to Pinnacle, Cooper's entity, for "consulting fees" even though Shoemaker did not do any consulting work.

#### a. The Failure to Disclose the Revenue Sharing Fees and the Conflict of Interest Resulting from These Arrangements

29. Total Wealth and Cooper made materially false misrepresentations and omissions to their clients about the revenue sharing arrangements, the fees received under these arrangements, and the payment of these fees to Cooper, McNamee and Shoemaker.

30. The disclosures in all of the Altus Funds' offering memoranda and, beginning in 2009, in Total Wealth's Form ADV Part II, Schedule F (later known as Part 2A) merely informed clients that Total Wealth "may" receive revenue sharing fees. But these disclosures failed to inform Total Wealth clients that Total Wealth already was receiving revenue sharing fees and failed to inform the investors about the sources, recipients, amounts and duration of the fees. This language appears in all of Total Wealth's subsequent Forms ADV, including those filed with the Commission.

31. Specifically, Total Wealth's Forms ADV filed March 28, 2011, August 23, 2011, May 2, 2012, February 26, 2013, April 5, 2013, and May 22, 2013 were false when filed. The Parts 2A of the Forms ADV falsely stated that Total Wealth "may have arrangements with certain Independent Managers whereby the Adviser receives a percentage of the fees charged by such Independent Managers." The Forms ADV also do not otherwise disclose the revenue sharing fees nor do they contain any reference to the Side Entities or these entities' affiliations with Total Wealth.

32. Like the Forms ADV, the Altus Funds' offering memoranda also failed to adequately disclose the revenue sharing arrangements. What little disclosure there is about the arrangements is buried in the memoranda and fails to disclose that Total Wealth routinely earned such fees. For example, page 60 of the Altus Capital Opportunity Fund memorandum states: "Some Private Funds *may* pay the General Partner or its affiliates a referral fee or a portion of the management fee paid by the Private fund to its general partner or investment adviser, including a portion of any incentive allocation" (emphasis added). Moreover, the existence, rate or prevalence of actual revenue sharing fee arrangements is not listed among the "other fees & expenses" identified in the "Summary of the Offering" placed at the beginning of the memoranda.

33. The respondents also did not disclose the existence, amount or extent of the revenue sharing fees paid to the respondents in other documents and communications.

34. The disclosures also failed to adequately disclose that Total Wealth already had a significant number of revenue sharing agreements in place. For example, according to the Altus Capital Opportunity Fund's audited financial statements, the fund had over $34 million in investments in fiscal year 2010. Of that amount, $31.7 million – or about 92% – was invested in entities that had revenue sharing agreements with Total Wealth.

35. Investors viewed the revenue sharing fees as material and would not have invested with Total Wealth if they knew that most of the funds in which the Altus Funds invested were, in turn, paying revenue sharing fees to Total Wealth. Moreover, several of these funds that paid revenue sharing fees were new enterprises and did not have any performance history making them riskier investments. Total Wealth's undisclosed financial incentive (in the form of the revenue sharing arrangements) to invest in such new and untested enterprises was material.

36. Also, many of the underlying investment funds that paid revenue sharing fees to Total Wealth had multi-year "lock-up" periods or set terms that prevented investors from withdrawing their money. So once invested, even if investors had learned about the revenue sharing fees, they would not have been able to obtain their funds.

37. The revenue fee sharing arrangement also created a clear conflict of interest for Total Wealth and Cooper. By receiving these fees for investing their clients into certain funds, Total Wealth and Cooper had an incentive to make those investments regardless of the performance of the underlying fund or the appropriateness of the investment. In fact, Total Wealth and Cooper had a persistent and pervasive practice of recommending and making investments in the underlying funds that paid revenue sharing fees. Doing so created extensive conflicts of interest that Total Wealth and Cooper had a duty to disclose fully.

38. Total Wealth and Cooper did not adequately disclose these conflicts of interest, which affected their ability to provide unbiased advice to their clients to invest in the Altus Funds. Total Wealth and Cooper breached their fiduciary duties to their clients by failing to adequately disclose the material information about the revenue sharing fee arrangements and the conflicts of interest posed by these arrangements.

39. McNamee and Shoemaker aided and abetted Total Wealth's and Cooper's failure to adequately disclose the material information about the revenue sharing fee arrangements, and they aided and abetted Total Wealth's and Cooper's failure to disclose Total Wealth's and Cooper's conflicts of interest that resulted from these arrangements. McNamee and Shoemaker also aided and abetted Total Wealth's and Cooper's breaches of fiduciary duty. As officers of Total Wealth and holders of several securities licenses, McNamee and Cooper knew, or were reckless in not knowing, that Total Wealth and Cooper had fiduciary responsibilities to their clients.

40. McNamee and Shoemaker knew about the revenue sharing agreements. They received a portion of Total Wealth's revenue sharing fees as a result of agreements that they signed with Total Wealth. McNamee and Shoemaker reviewed the brochures, offering memoranda, statements, Forms ADV and other materials that Total Wealth provided to its clients. McNamee formally signed off on these materials after he replaced Shoemaker as chief compliance officer in 2011. McNamee and Shoemaker also met with prospective clients and investors, prepared investment recommendations for those clients, sold the Altus investments to clients, and collected their portion of the revenue sharing fees. But they failed to disclose the truth about the revenue sharing agreements to investors. As a result, McNamee and Shoemaker substantially assisted Total Wealth and Cooper's failure to sufficiently disclose the fee arrangements and the resulting conflicts.

**b. The Scheme to Mislead Investors about the Revenue Sharing Fees**

41. The respondents devised and orchestrated a fraudulent scheme to collect and conceal their receipt of revenue sharing fees through their Side Entities. The respondents structured the Altus Funds and their disclosures so the clients investing in the Altus Funds would not know that those funds held risky investments paying revenue sharing fees back to the respondents.

42. The respondents took several steps in furtherance of the scheme. In December 2008, Total Wealth hired a compliance consultant with fifteen years of experience in the industry. But Total Wealth fired him after he had prepared early versions of the Form ADV that more fulsomely disclosed the revenue sharing fee arrangements. In fact, although the consultant knew about the revenue sharing fee agreements and asked Shoemaker to see copies of the agreements, the respondents never provided them to him and the consultant never saw the agreements. Nonetheless, the consultant prepared an October 2009 version of Total Wealth's ADV Part II, Schedule F that stated that Total Wealth "routinely purchases a certain type of security . . . [and] has entered into solicitation agreements with the firms offering the investment product and as a result of placing the client in those investment products, the Adviser may

receive a percentage of the investment advisory fees charged by the firm." Total Wealth filed this Schedule F with its Form ADV in October 2009.

43. After the consultant drafted this language disclosing the revenue sharing arrangements, Total Wealth fired him on or around October 2009. Shortly thereafter, Total Wealth hired a rookie compliance consultant with little relevant experience. Then, Total Wealth's May 2010 Schedule F, and all subsequent Forms ADV and accompanying schedules and parts, omitted the language recommended by the fired consultant. Total Wealth filed the regulatory replacement to the Schedule F, Part 2A (known as the "firm brochure") in March 2011 along with its Form ADV. The March 2011 Part 2A, and all subsequent Forms ADV and Parts 2A, falsely stated only that Total Wealth "may" have revenue sharing arrangements.

44. Meanwhile, in November 2009, McNamee and Shoemaker, through Capita and Financial Council respectively, began issuing invoices to Cooper that concealed the revenue sharing fees. These false invoices charged "consulting fees" even when the entities performed virtually no consulting work. These false invoices disguised the flow of income from the revenue sharing fees.

45. Also, around the same time that Total Wealth hired the new compliance consultant, it hired a fund administrator to assist with the newly-formed Altus Fund. Like the new compliance consultant, the accountant for the administrator was inexperienced, having no prior experience doing investment fund portfolio accounting. Later, in early to mid-2010, the administrator encountered difficulties obtaining the documents and information from Total Wealth, the Altus Funds, and their underlying funds that were necessary to prepare timely and reliable statement information for Altus Fund investors. On November 30, 2010, Total Wealth terminated its relationship with the fund administrator and subsequently hired an administrator in the Bahamas.

46. In addition, in July 2010, Total Wealth began preliminary discussions with an auditor about auditing the Altus Capital Opportunity Fund. Total Wealth was required to comply with the Custody Rule. 17 C.F.R. §275.206(4)-2 (the "Custody Rule"). As part of its compliance with the Custody Rule, Total Wealth was required to comply with Sections 206(4)-2(a)(2), (3), and (4) unless it availed itself of the audit exception by obtaining an annual audit from an auditor subject to regular PCAOB inspection. When the proposed new auditor emailed a draft engagement letter to Cooper, it included an excerpt from the SEC's "Staff Responses to Questions About the Custody Rule" regarding audits of pooled investment vehicles and the Custody Rule, which reiterated the rule's requirement that the auditor needed to be subject to regular PCAOB inspection. Total Wealth then elected not to hire that auditor.

47. Instead, in late 2010, Total Wealth hired an unqualified accountant (the "Auditing Firm") to audit the Altus Capital Opportunity Fund. The owner and sole individual associated with the Auditing Firm did not verify that he or his firm was subject to regular PCAOB inspection, only that he and his firm were subject to "oversight." As a result, the Auditing Firm could not fulfill Total Wealth's obligation under the Custody Rule to have audits performed by an auditor subject to regular PCAOB inspection.

48. The Auditing Firm also lacked independence as defined by Regulation S-X. The Custody Rule requires that Regulation S-X independence standards be met for the audit to satisfy the audit exception under the Custody Rule. *See* 17 C.F.R. §§ 275.206(4)-2(b)(4)(ii), 275.206(4)-2(d)(3) (independent public accountant must meet standards of Regulation S-X). As part of the Auditing Firm's engagement by Total Wealth, the Auditing Firm prepared the Altus Capital Opportunity Fund's 2010 financial statements. Then, Total Wealth instructed the Auditing Firm to audit those very financial statements, which it did. Under Regulation S-X, an accountant is not independent if he provides certain bookkeeping and other services related to the accounting records or financial statements unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. *See* Rule 2-01(c)(4)(i) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4)(i); *Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence*, 68 Fed. Reg. 6006, 6011 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249 and 274) (it is a basic principle that an auditor cannot audit his own work and remain independent).

49. Cooper served as one of the principal contacts for the Auditing Firm and helped the Auditing Firm obtain information that it then used to prepare the financial statements. Cooper reviewed those financial statements and signed the management representation letter.

50. McNamee also served as one of the Auditing Firm's principal contacts during the audit and preparation of financial statements. McNamee helped the Auditing Firm obtain the information that it used to prepare the financial statements, and McNamee reviewed those financial statements.

51. In short, throughout this time period, Total Wealth and Cooper placed investors in the Altus Capital Opportunity Fund, allowing Cooper, McNamee and Shoemaker to obtain revenue sharing fees. Because Total Wealth, and not the Altus Capital Opportunity Fund, collected the revenue sharing fees, those fees did not appear directly on the fund's 2010 audited financial statements prepared and audited by the Auditing Firm. Total Wealth funneled the revenue sharing fees through the Side Entities, companies that apparently were created just for that purpose. Invoices were created to give the appearance that the fees were just payments for consulting work, even though virtually no consulting work was ever done. The professionals who inquired about the revenue sharing agreements or asked for information about them either were not hired or were fired. This entire course of conduct by Total Wealth and Cooper was inherently deceptive, and had the principal purpose and effect of facilitating a scheme to conceal the revenue sharing fees while inducing investors to place their money in the Altus Capital Opportunity Fund.

52. McNamee and Shoemaker aided and abetted Total Wealth and Cooper's fraudulent scheme. McNamee and Shoemaker created and submitted the false invoices to collect the revenue sharing fees, which gave the false appearance that the fees were for consulting when, in fact, they were for revenue sharing arrangements that had not been disclosed. Moreover, these fees were paid to entities that McNamee and Shoemaker apparently created solely for the purpose of receiving fees. Also, McNamee and Shoemaker substantially assisted in the scheme because each knew about the revenue sharing agreements and reviewed the materials provided to Total Wealth clients, but failed to make sure that these arrangements were sufficiently disclosed.

### 3. Total Wealth's Due Diligence Efforts

53. Total Wealth and Cooper also misled Altus investors about the due diligence they conducted on the holdings in the Altus Funds. Cooper was responsible for selecting the investments recommended by Total Wealth and held by the Altus Funds, and he identified those investments mainly through word of mouth.

54. In face-to-face meetings and emails with potential investors, Cooper represented that he conducted "rigorous due diligence" to choose investments. The offering memoranda and the promotional materials for the Altus Capital Opportunity Fund represented that the "leadership team . . . conduct[ed] regular reviews of all Fund investments including on-site manager visits and in-depth qualitative and quantitative due diligence." This representation appeared in the executive summary provided to prospective investors and on the glossy folder that contained the prospective investor packet.

55. Such "in-depth qualitative and quantitative due diligence" was important to investors because Total Wealth and its investment adviser representatives were the clients' only potential source of any information about the holdings in the Altus Funds. Moreover, as both the offering memoranda and the subscription agreement acknowledged, the profitability of the fund depended upon the abilities of Altus Management and Total Wealth to assess the future course of price movement of securities and to choose private investment funds.

56. Total Wealth's and Cooper's representations about due diligence are false. They did not conduct the due diligence they represented to investors. For many, if not all, of the investments held by the Altus Funds, Total Wealth did not perform any quantitative analysis of the investments. Total Wealth received promotional materials, subscription agreements, and the self-reported and unverified performance history of the underlying funds. But Total Wealth failed to review or analyze such documents or obtain any third-party due diligence of the underlying funds.

57. Moreover, Total Wealth did not have audited financial statements for many of the private funds held by the Altus Capital Opportunity Fund. Even when Total Wealth did obtain audited financials, it either did not review them or did not obtain them for all the relevant periods before it invested client funds. Cooper relied on the underlying funds for almost all of his information about the funds.

58. Indeed, as early as 2010, Total Wealth knew at least two of the funds held in the Altus Capital Opportunity Fund had financial issues. But this did not dissuade Total Wealth from continuing to place clients in the Altus Capital Opportunity Fund or to hold the troubled funds in the Altus Capital Opportunity Fund. The audited financial statements for one of these funds revealed that it had expenses (consisting almost exclusively of management fees, commissions, and incentive fees) of over $700,000, but income of only $5,000 – and that the only assets of this fund were cash and T-bills. In another fund, Cooper knew, prior to investing, that the fund generated investor returns by "borrowing the carry," *i.e.*, paying interest to investors from the capital it raised from other investors. Nonetheless, the Altus Capital Opportunity Fund invested with this fund. The company's 2010 audited financial statements,

prepared in 2012, showed that it was insolvent. The Altus Capital Opportunity Fund is still invested with both of the funds described here.

59. Total Wealth and Cooper breached their fiduciary duties by failing to conduct the due diligence they claimed they were doing and making misrepresentations about the due diligence they performed.

### 4. Total Wealth's Custody Rule Violation

60. As the managing member of Altus Management, which is the general partner of the Altus Funds, Total Wealth had custody of the funds and securities of its clients, the Altus funds, as well the funds and securities of the investors in those funds who are Total Wealth clients. As such, Total Wealth was required to comply directly with all the requirements of the Custody Rule, 17 C.F.R. §275.206(4)-2, unless it satisfied the requirements of the audit exception, in which case it does not have to comply with Rule 206(4)-(2)(a)(2) (notice to clients) or (a)(3) (account statements to clients) and "will be deemed to have complied" with (a)(4) (independent verification by annual examination). Total Wealth neither complied with the provisions of Rule 206(4)-(2)(a)(4), nor did it satisfy this provision by taking the audit approach provided in 206(4)-2(b)(4), that is by having the Altus Funds audited annually by an independent public accountant who is registered with, and subject to regular inspection by, the PCAOB and by distributing audited financial statements prepared in accordance with GAAP to the Altus investors within 120 days of the end of its fiscal year. 17 C.F.R. §275. 206(4)-2(b)(4)(ii) (audit must be conducted "by an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by the Public Company Accounting Oversight Board in accordance with its rules") (emphasis added).

61. In its ADV filings since March 2011, Total Wealth has claimed that it has complied with the Custody Rule by having the Altus Funds audited annually by the Auditing Firm. Total Wealth also identifies the Auditing Firm as the auditor of the Altus Portfolio Series Funds in the offering memoranda for the funds in this series.

62. These representations are not true. The only audit that the Auditing Firm performed was of the 2010 financial statements of the Altus Capital Opportunity Fund. But the Auditing Firm was not independent of the Altus Capital Opportunity Fund as required by Regulation S-X because the Auditing Firm had prepared the 2010 financial statements for the Altus Capital Opportunity Fund prior to conducting his audit. The Auditing Firm also was not subject to regular inspection by the PCAOB. Thus, Total Wealth could not use that audit to avail itself of the audit exception to the Custody Rule.

63. Cooper and McNamee aided and abetted Total Wealth's Custody Rule violation. Both were the Auditing Firm's principal contacts at Total Wealth during the Auditing Firm's preparation of the 2010 financial statements and the Auditing Firm's audit of those statements. Each knew or was reckless in not knowing that the Auditing Firm was required to be subject to regular inspection by the PCAOB if the Auditing Firm's audits were to be used to satisfy the audit exception to the Custody Rule. As a result, both Cooper and McNamee knew, or were reckless in not knowing, that the Auditing Firm was not conducting annual audits as required by

the rule, did not possess the requisite independence, and was not subject to regular PCAOB inspection as required by the Custody Rule. They also provided the Auditing Firm with information that the Auditing Firm used to prepare the Altus Fund financial statements, and reviewed those financial statements. Cooper also signed the management representation letter. Thus, Cooper and McNamee provided substantial assistance to Total Wealth's Custody Rule violations.

## E. VIOLATIONS

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

a. engaging in a scheme to defraud investors by directing client money to funds that paid revenue-sharing fees and by collecting, and concealing the receipt of, revenue-sharing fees in violation of Sections 17(a)(1) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5(a) and (c); and

b. making, and obtaining money or property by means of, material misrepresentations and omissions regarding the receipt of revenue-sharing fees and the amount of due diligence performed regarding the investments held by the Altus Funds in violation of Section 17(a)(2) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5(b).

65. As a result of the conduct described above, Total Wealth willfully violated Sections 206(1), 206(2), 206(4) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser, and Rule 206(4)-8, promulgated thereunder, by directing client money to funds that paid revenue sharing fees, without adequate disclosure, by engaging in a scheme to collect and conceal their receipt of the revenue sharing fees, and by otherwise misleading clients regarding these fees and its due diligence efforts, in breach of its fiduciary duties in violation of 206(1), 206(2), 206(4) of the Advisers Act and Rule 206(4)-8.

66. As a result of the conduct described above, by failing to obtain independent verification of client funds and securities as set forth in Rule 206(4)-(2)(a), Total Wealth willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-2, promulgated thereunder, which makes it a fraudulent, deceptive or manipulative act under Section 206(4) for any registered investment adviser to have custody of clients' funds or securities in a pooled investment vehicle unless that investment adviser complies with Rule 206(4)-2(a) or with the exceptions set forth in Rule 206(4)-2(b).

67. As a result of the conduct described above, by making misleading and false statements regarding the revenue sharing fees, Total Wealth's custody of client funds, the independence of the Altus Funds' auditor, and the annual audits of the Altus Funds, Total Wealth willfully violated Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission . . . or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

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 Respondent Total Wealth's Offer.

Accordingly, pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, it is hereby ORDERED that:

A. Respondent Total Wealth shall cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 206(4)-2 and 206(4)-8 promulgated thereunder.

B. Respondent Total Wealth's registration as an investment adviser be, and it is hereby is, revoked.

C. The SEC will forego seeking from Total Wealth any disgorgement or civil penalty in this proceeding.

By the Commission.

Brent J. Fields
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 ACT OF 1933**
**Release No. 9990 / December 14, 2015**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76643 / December 14, 2015**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 4292 / December 14, 2015**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 31936 / December 14, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-15842**

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| **In the Matter of**<br><br>**TOTAL WEALTH MANAGEMENT, INC., JACOB KEITH COOPER, NATHAN MCNAMEE, AND DOUGLAS DAVID SHOEMAKER**<br><br>**Respondents.** | **ORDER MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940 AS TO RESPONDENTS NATHAN MCNAMEE AND DOUGLAS DAVID SHOEMAKER** |

**I.**

On April 15, 2014, the Securities and Exchange Commission ("Commission") instituted proceedings pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Respondents Total Wealth Management, Inc. ("Total Wealth"), Jacob Keith Cooper ("Cooper"), Nathan McNamee ("McNamee"), and Douglas David Shoemaker ("Shoemaker").



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## II.

McNamee and Shoemaker have each 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, McNamee and Shoemaker each consent to the entry of this Order Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 15(b) of the Securities Exchange Act of 1934, Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, as set forth below.

## III.

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

### A. SUMMARY

1. This proceeding involved misconduct by Total Wealth, a registered investment adviser; Cooper, its co-founder, sole owner, and CEO; McNamee, its former president and chief compliance officer; and Shoemaker, its co-founder and former chief compliance officer. The Respondents engaged in this conduct in connection with investments made in the unregistered Altus Capital Opportunity Fund, LP ("Altus Capital Opportunity Fund") and a series of unregistered fund of funds referred to as the "Altus Portfolio Series" (collectively, with the Altus Capital Opportunity Fund, the "Altus Funds").

2. Starting in at least 2009, Total Wealth and Cooper breached their fiduciary duties to their clients and investors through a fraudulent scheme to collect, and conceal their receipt of, undisclosed revenue sharing fees derived from investments they recommended to their clients. Total Wealth, Cooper, McNamee, and Shoemaker each received undisclosed revenue sharing fees, which were funneled through entities created by the individuals to mask their receipt of the fees. Total Wealth also violated the custody rule by failing to obtain annual audits from an independent public accountant subject to regular inspection by the Public Company Accounting Oversight Board ("PCAOB").

3. McNamee, a former investment adviser representative with Total Wealth and former registered representative, and Shoemaker, a current investment adviser representative with Total Wealth and former registered representative, aided, abetted, and caused Total Wealth's and Cooper's violations. McNamee and Shoemaker, who knew about the revenue sharing arrangements and the related misrepresentations, likewise failed to fully disclose those arrangements to clients. Cooper and McNamee also aided, abetted, and caused Total Wealth's custody rule violation.

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

## B. <u>RESPONDENTS</u>

4. Total Wealth is a California corporation with its principal place of business in San Diego, California. Total Wealth registered with the Commission as an investment adviser on November 25, 2009, and as of April 2014 had approximately $90.2 million under management in 481 client accounts. Total Wealth is the owner and managing member of Altus Management and the investment adviser to the Altus Capital Opportunity Fund and the Altus Portfolio Series Funds. Pursuant to an Preliminary Injunction entered on February 12, 2015 in the case captioned *Securities and Exchange Commission v. Total Wealth Management, Inc., et al.*, pending in the United States District Court for the Southern District of California, a permanent receiver was appointed to take control of Total Wealth, as well as its subsidiaries and affiliates.

5. Cooper resides in Washington, Utah. He is the co-founder, sole owner, and CEO of Total Wealth. He previously held Series 6 and 63 licenses. Cooper was a registered representative and associated with three broker-dealers and another investment adviser from 2001 through 2005. He resigned from Sun America Securities, Inc. in 2005. In 2007, Sun America reported the receipt and settlement of a customer complaint that Cooper forged signatures on account application paperwork and failed to explain the difference between variable life products versus mutual fund products. Thereafter, he co-founded Total Wealth with Shoemaker.

6. McNamee resides in Haslemere, England and previously resided in Hurricane, Utah. He was an investment adviser representative with Total Wealth from 2009 to 2013. He served as Total Wealth's president beginning in early 2011 and its chief compliance officer beginning in May 2011. McNamee previously held Series 7, 63, and 66 licenses. McNamee was a registered representative of Financial Telesis, Inc., a registered broker-dealer, from December 2009 through December 2010.

7. Shoemaker resides in San Diego, California. He is the co-founder, former chief compliance officer (until 2011), and a current investment adviser representative of Total Wealth. Shoemaker holds a Series 65 license and previously held Series 6 and 63 licenses. Shoemaker was a registered representative and associated with the same broker-dealers and investment adviser as Cooper from 2001 through 2005.

## C. <u>OTHER RELEVANT ENTITIES</u>

8. Altus Capital Management, LLC ("Altus Management") is a Delaware limited liability corporation with its principal place of business in San Diego, California. Altus Management is the general partner to the Altus Capital Opportunity Fund and the Altus Portfolio Series. Altus Management has never registered with the Commission in any capacity and has no disciplinary history with the Commission.

9. The Altus Capital Opportunity Fund is a Delaware limited partnership and an unregistered fund of funds. It first filed a Form D on January 25, 2010 claiming exemption from registration under Rule 506 of Regulation D of the Securities Act and an exclusion from the definition of "investment company" in Section 3(c)(1) of the Investment Company Act.

10. Altus Conservative Portfolio Series, LP, Altus Focused Growth Portfolio Series, LP, Altus Income Portfolio Series, LP, Altus Growth Portfolio Series, LP, Altus Moderate Growth Portfolio Series, LP, and Altus Moderate Portfolio Series, LP are a family of Delaware limited partnerships. They are a series of unregistered funds of funds referred to as the "Altus Portfolio Series" (collectively, the "Altus Portfolio Series Funds"). The Altus Portfolio Series Funds filed Forms D in 2011 claiming exemption from registration under Rule 506 and Section 3(c)(1) of the Investment Company Act.

11. Capita Advisors, Inc. ("Capita") is a California corporation with its principal place of business in San Diego, California. Capita purports to be a consulting company, and was founded and is operated solely by McNamee. Capita has never registered with the Commission in any capacity and has no disciplinary history with the Commission.

12. Financial Council, Inc. ("Financial Council") is a California corporation with its principal place of business in San Diego, California. Financial Council purports to be a consulting company, and was founded and is operated solely by Shoemaker. Financial Council has never registered with the Commission in any capacity and has no disciplinary history with the Commission.

13. Pinnacle Wealth Group, Inc. ("Pinnacle") is a California corporation with its principal place of business in San Diego, California. Pinnacle purports to be a consulting company, and was founded and is operated solely by Cooper. Pinnacle has never registered with the Commission in any capacity and has no disciplinary history with the Commission.

## D. FACTUAL ALLEGATIONS

### 1. Background of the Altus Funds

14. Total Wealth, which was founded by Cooper and Shoemaker, is an investment adviser to the Altus Funds. Total Wealth is also the owner and managing member of Altus Management, which is the general partner to the Altus Funds.

15. Cooper organized the Altus Capital Opportunity Fund in late 2009 in order to allow Total Wealth clients to pool their money to meet the mandatory minimum investment requirement for funds for which they otherwise might not qualify.

16. Two years later, in 2011, Cooper established the Altus Portfolio Series Funds, a series of pooled investment funds. The Altus Funds – Altus Capital Opportunity Fund and the Altus Portfolio Series Funds – invested their assets in other funds, which were selected by Cooper. The Altus Capital Opportunity Fund and the Altus Portfolio Series Funds held many of the same investments.

17. Cooper, Shoemaker, and McNamee made all of the investment decisions and recommendations for their respective Total Wealth clients, including those who invested in the Altus Funds. These clients paid for this advice based on the amount of assets that were being managed. As the CEO and owner of Total Wealth, Cooper directly benefited from the fees Total Wealth received.

18. Total Wealth identified potential new clients through paid weekly radio broadcasts, existing client referrals, webinars, the company website, and meet-and-greets through a local speaker's bureau or a free lunch. Prior to the formation of the Altus Capital Opportunity Fund, existing Total Wealth clients could choose to place their investment funds directly in the offerings recommended by Respondents.

19. Starting in 2010, Total Wealth, Cooper, Shoemaker, and McNamee began advising their preexisting clients to transfer their individual investments to the Altus Capital Opportunity Fund. At the same time, they also began offering the Altus Capital Opportunity Fund to new Total Wealth clients and later, in 2011, they began offering the Altus Portfolio Series Funds to Total Wealth clients.

20. Cooper, McNamee, and Shoemaker met with potential investors prior to accepting them as clients of Total Wealth or as investors in the Altus Funds. As investment adviser representatives, they then prepared written investment recommendations and discussed them with their prospective clients. Total Wealth provided clients with prospective investor packets and brochures, including a packet designed specifically for prospective investors in the Altus Funds. The packet frequently included an executive summary of the fund, which was created and approved by Cooper, who solicited input from McNamee and Shoemaker. Total Wealth also provided the executive summary to potential investors who participated in its client webinars.

21. Investors in the Altus Funds typically received an offering memorandum, a limited partnership agreement, and a subscription agreement. In May 2011, when McNamee became the chief compliance officer, he "signed off" on all material provided to prospective investors. The funds' offering memoranda state that Altus Management will "adhere" to the provisions of the Investment Advisers Act. The offering memoranda also specifically state, in all capital letters, that "provisions referenced to [Altus Management] . . . may also be deemed to apply, and should be read to apply equally to [Total Wealth], and vice versa where relevant."

22. In May 2011, McNamee also assumed responsibility for verifying that all investors received the current Form ADV for Total Wealth. Shoemaker signed the firm's Forms ADV for Total Wealth in 2009 and 2010, Cooper signed the Forms ADV for Total Wealth in 2011, and McNamee signed the Forms ADV for Total Wealth thereafter.

23. Once a client invested in one of the Altus Funds, Altus Management had the discretion to buy and sell that client's holdings without notice. Total Wealth clients who invested directly in the Altus Funds typically did not receive offering documents regarding the underlying investments held by the Altus Funds. Instead, they received statements directly from the Altus Funds (via Total Wealth), and the only offering memorandum that they may have seen are those of the Altus Funds themselves. As a result, there was little to no transparency provided to investors that would allow them to evaluate the merit of the underlying holdings of the Altus Funds or whether Total Wealth possessed any relationship to those entities. As of April 2014, approximately 75% of Total Wealth's clients were invested in one or more of the Altus Funds. Likewise, approximately 75% of Total Wealth's clients were individuals.

24. As of April 2013, the Altus Capital Opportunity Fund had a gross asset value of approximately $43.5 million held for 86 beneficial owners. As of February 2013, the Altus Portfolio Series Funds collectively held gross assets of approximately $10.9 million.

### 2. Total Wealth's Revenue Sharing Fee Arrangements

25. Starting in at least February 2008, prior to the creation of the Altus Capital Opportunity Fund, Total Wealth had revenue sharing arrangements in place with several investment funds. Under these agreements, these other funds paid Total Wealth a fee when Total Wealth placed its clients' investments in those funds. Cooper signed all of the revenue sharing agreements on behalf of Total Wealth.

26. Total Wealth paid Cooper, McNamee, and Shoemaker a portion of the revenue sharing fees it received. Through written agreements signed by McNamee and Shoemaker, Total Wealth agreed to pay each person 70%-80% of the revenue sharing fees earned for every Total Wealth client he placed into the underling funds. Cooper received his revenue sharing fees without the use of a written agreement.

27. About the same time that the Altus Capital Opportunity Fund was established, Cooper formed Pinnacle, and he advised Shoemaker and McNamee to form Financial Council and Capita, respectively.

28. Pinnacle, Financial Council, and Capita (the "Side Entities") received in their bank accounts the revenue sharing fees paid to their respective owners, and these Side Entities performed virtually no consulting work. Typically, Cooper, McNamee and Shoemaker funneled their revenue sharing payments through the Side Entities. For the collection of revenue sharing fees, Cooper simply paid money directly from Total Wealth to Pinnacle. McNamee and Shoemaker issued invoices on behalf of their Side Entities, and these invoices frequently characterized the fees as something other than revenue sharing fees, concealing the true nature of the fees paid. For example, in 2010, Financial Council, Shoemaker's entity, consistently submitted invoices to Pinnacle, Cooper's entity, for "consulting fees" even though Shoemaker did not do any consulting work.

#### a. The Failure to Disclose the Revenue Sharing Fees and the Conflict of Interest Resulting from These Arrangements

29. Total Wealth and Cooper made materially false misrepresentations and omissions to their clients about the revenue sharing arrangements, the fees received under these arrangements, and the payment of these fees to Cooper, McNamee and Shoemaker.

30. The disclosures in all of the Altus Funds' offering memoranda and, beginning in 2009, in Total Wealth's Form ADV Part II, Schedule F (later known as Part 2A) merely informed clients that Total Wealth "may" receive revenue sharing fees. But these disclosures failed to inform Total Wealth clients that Total Wealth already was receiving revenue sharing fees and failed to inform the investors about the sources, recipients, amounts and duration of the fees. This language appears in all of Total Wealth's subsequent Forms ADV, including those filed with the Commission.

31. Specifically, Total Wealth's Forms ADV filed March 28, 2011, August 23, 2011, May 2, 2012, February 26, 2013, April 5, 2013, and May 22, 2013 were false when filed. The Parts 2A of the Forms ADV falsely stated that Total Wealth "may have arrangements with certain Independent Managers whereby the Adviser receives a percentage of the fees charged by such Independent Managers." The Forms ADV also do not otherwise disclose the revenue sharing fees nor do they contain any reference to the Side Entities or these entities' affiliations with Total Wealth.

32. Like the Forms ADV, the Altus Funds' offering memoranda also failed to adequately disclose the revenue sharing arrangements. What little disclosure there was about the arrangements is buried in the memoranda and fails to disclose that Total Wealth routinely earned such fees. For example, page 60 of the Altus Capital Opportunity Fund memorandum states: "Some Private Funds *may* pay the General Partner or its affiliates a referral fee or a portion of the management fee paid by the Private fund to its general partner or investment adviser, including a portion of any incentive allocation" (emphasis added). Moreover, the existence, rate or prevalence of actual revenue sharing fee arrangements is not listed among the "other fees & expenses" identified in the "Summary of the Offering" placed at the beginning of the memoranda.

33. Respondents also did not disclose the existence, amount or extent of the revenue sharing fees paid to Respondents in other documents and communications.

34. The disclosures also failed to adequately disclose that Total Wealth already had a significant number of revenue sharing agreements in place. For example, according to the Altus Capital Opportunity Fund's audited financial statements, the fund had over $34 million in investments in fiscal year 2010. Of that amount, $31.7 million – or about 92% – was invested in entities that had revenue sharing agreements with Total Wealth.

35. Investors viewed the revenue sharing fees as material and would not have invested with Total Wealth if they knew that most of the funds in which the Altus Funds invested were, in turn, paying revenue sharing fees to Total Wealth. Moreover, several of these funds that paid revenue sharing fees were new enterprises and did not have any performance history making them riskier investments. Total Wealth's undisclosed financial incentive (in the form of the revenue sharing arrangements) to invest in such new and untested enterprises was material.

36. Also, many of the underlying investment funds that paid revenue sharing fees to Total Wealth had multi-year "lock-up" periods or set terms that prevented investors from withdrawing their money. So once invested, even if investors had learned about the revenue sharing fees, they would not have been able to obtain their funds.

37. The revenue fee sharing arrangement also created a clear conflict of interest for Total Wealth and Cooper. By receiving these fees for investing their clients into certain funds, Total Wealth and Cooper had an incentive to make those investments regardless of the performance of the underlying fund or the appropriateness of the investment. In fact, Total Wealth and Cooper had a persistent and pervasive practice of recommending and making investments in the underlying funds that paid revenue sharing fees. Doing so created extensive conflicts of interest that Total Wealth and Cooper had a duty to disclose fully.

38. Total Wealth and Cooper did not adequately disclose these conflicts of interest, which affected their ability to provide unbiased advice to their clients to invest in the Altus Funds. Total Wealth and Cooper breached their fiduciary duties to their clients by failing to adequately disclose the material information about the revenue sharing fee arrangements and the conflicts of interest posed by these arrangements.

39. McNamee and Shoemaker aided and abetted Total Wealth's and Cooper's failure to adequately disclose the material information about the revenue sharing fee arrangements, and they aided and abetted Total Wealth's and Cooper's failure to disclose Total Wealth's and Cooper's conflicts of interest that resulted from these arrangements. McNamee and Shoemaker also aided and abetted Total Wealth's and Cooper's breaches of fiduciary duty. As officers of Total Wealth and holders of several securities licenses, McNamee and Cooper knew, or were reckless in not knowing, that Total Wealth and Cooper had fiduciary responsibilities to their clients.

40. McNamee and Shoemaker knew about the revenue sharing agreements. They received a portion of Total Wealth's revenue sharing fees as a result of agreements that they signed with Total Wealth. McNamee and Shoemaker reviewed the brochures, offering memoranda, statements, Forms ADV and other materials that Total Wealth provided to its clients. McNamee formally signed off on these materials after he replaced Shoemaker as chief compliance officer in 2011. McNamee and Shoemaker also met with prospective clients and investors, prepared investment recommendations for those clients, sold the Altus investments to clients, and collected their portion of the revenue sharing fees. But they failed to disclose the truth about the revenue sharing agreements to investors. As a result, McNamee and Shoemaker substantially assisted Total Wealth and Cooper's failure to sufficiently disclose the fee arrangements and the resulting conflicts.

### b. The Scheme to Mislead Investors about the Revenue Sharing Fees

41. Respondents devised and orchestrated a fraudulent scheme to collect and conceal their receipt of revenue sharing fees through their Side Entities. Respondents structured the Altus Funds and their disclosures so the clients investing in the Altus Funds would not know that those funds held risky investments paying revenue sharing fees back to the Respondents.

42. Respondents took several steps in furtherance of the scheme. In December 2008, Total Wealth hired a compliance consultant with fifteen years of experience in the industry. But Total Wealth fired him after he had prepared early versions of the Form ADV that more fulsomely disclosed the revenue sharing fee arrangements. In fact, although the consultant knew about the revenue sharing fee agreements and asked Shoemaker to see copies of the agreements, the Respondents never provided them to him and the consultant never saw the agreements. Nonetheless, the consultant prepared an October 2009 version of Total Wealth's ADV Part II, Schedule F that stated that Total Wealth "routinely purchases a certain type of security . . . [and] has entered into solicitation agreements with the firms offering the investment product and as a result of placing the client in those investment products, the Adviser may receive a percentage of the investment advisory fees charged by the firm." Total Wealth filed this Schedule F with its Form ADV in October 2009.

43. After the consultant drafted this language disclosing the revenue sharing arrangements, Total Wealth fired him on or around October 2009. Shortly thereafter, Total Wealth hired a rookie compliance consultant with little relevant experience. Then, Total Wealth's May 2010 Schedule F, and all subsequent Forms ADV and accompanying schedules and parts, omitted the language recommended by the fired consultant. Total Wealth filed the regulatory replacement to the Schedule F, Part 2A (known as the "firm brochure") in March 2011 along with its Form ADV. The March 2011 Part 2A, and all subsequent Forms ADV and Parts 2A, falsely stated only that Total Wealth "may" have revenue sharing arrangements.

44. Meanwhile, in November 2009, McNamee and Shoemaker, through Capita and Financial Council respectively, began issuing invoices to Cooper that concealed the revenue sharing fees. These false invoices charged "consulting fees" even when the entities performed virtually no consulting work. These false invoices disguised the flow of income from the revenue sharing fees.

45. Also, around the same time that Total Wealth hired the new compliance consultant, it hired a fund administrator to assist with the newly-formed Altus Fund. Like the new compliance consultant, the accountant for the administrator was inexperienced, having no prior experience doing investment fund portfolio accounting. Later, in early to mid-2010, the administrator encountered difficulties obtaining the documents and information from Total Wealth, the Altus Funds, and their underlying funds that were necessary to prepare timely and reliable statement information for Altus Fund investors. On November 30, 2010, Total Wealth terminated its relationship with the fund administrator and subsequently hired an administrator in the Bahamas.

46. In addition, in July 2010, Total Wealth began preliminary discussions with an auditor about auditing the Altus Capital Opportunity Fund. Total Wealth was required to comply with the Custody Rule. 17 C.F.R. §275.206(4)-2 (the "Custody Rule"). As part of its compliance with the Custody Rule, Total Wealth was required to comply with Sections 206(4)-2(a)(2), (3), and (4) unless it availed itself of the audit exception by obtaining an annual audit from an auditor subject to regular PCAOB inspection. When the proposed new auditor emailed a draft engagement letter to Cooper, it included an excerpt from the SEC's "Staff Responses to Questions About the Custody Rule" regarding audits of pooled investment vehicles and the Custody Rule, which reiterated the rule's requirement that the auditor needed to be subject to regular PCAOB inspection. Total Wealth then elected not to hire that auditor.

47. Instead, in late 2010, Total Wealth hired an unqualified accountant (the "Auditing Firm") to audit the Altus Capital Opportunity Fund. The owner and sole individual associated with the Auditing Firm did not verify that he or his firm was subject to regular PCAOB inspection, only that he and his firm were subject to "oversight." As a result, the Auditing Firm could not fulfill Total Wealth's obligation under the Custody Rule to have audits performed by an auditor subject to regular PCAOB inspection.

48. The Auditing Firm also lacked independence as defined by Regulation S-X. The Custody Rule requires that Regulation S-X independence standards be met for the audit to satisfy the audit exception under the Custody Rule. *See* 17 C.F.R. §§ 275.206(4)-2(b)(4)(ii), 275.206(4)-2(d)(3) (independent public accountant must meet standards of Regulation S-X). As

part of the Auditing Firm's engagement by Total Wealth, the Auditing Firm prepared the Altus Capital Opportunity Fund's 2010 financial statements. Then, Total Wealth instructed the Auditing Firm to audit those very financial statements, which it did. Under Regulation S-X, an accountant is not independent if he provides certain bookkeeping and other services related to the accounting records or financial statements unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. *See* Rule 2-01(c)(4)(i) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4)(i); *Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence*, 68 Fed. Reg. 6006, 6011 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249 and 274) (it is a basic principle that an auditor cannot audit his own work and remain independent).

49. Cooper served as one of the principal contacts for the Auditing Firm and helped the Auditing Firm obtain information that it then used to prepare the financial statements. Cooper reviewed those financial statements and signed the management representation letter.

50. McNamee also served as one of the Auditing Firm's principal contacts during the audit and preparation of financial statements. McNamee helped the Auditing Firm obtain the information that it used to prepare the financial statements, and McNamee reviewed those financial statements.

51. Throughout the relevant time period, Total Wealth and Cooper placed investors in the Altus Capital Opportunity Fund, allowing Cooper, McNamee and Shoemaker to obtain revenue sharing fees. Because Total Wealth, and not the Altus Capital Opportunity Fund, collected the revenue sharing fees, those fees did not appear directly on the fund's 2010 audited financial statements prepared and audited by the Auditing Firm. Total Wealth funneled the revenue sharing fees through the Side Entities, companies that apparently were created just for that purpose. Invoices were created to give the appearance that the fees were just payments for consulting work, even though virtually no consulting work was ever done. The professionals who inquired about the revenue sharing agreements or asked for information about them either were not hired or were fired. This entire course of conduct by Total Wealth and Cooper was inherently deceptive, and had the principal purpose and effect of facilitating a scheme to conceal the revenue sharing fees while inducing investors to place their money in the Altus Capital Opportunity Fund.

52. McNamee and Shoemaker aided and abetted Total Wealth and Cooper's fraudulent scheme. McNamee and Shoemaker created and submitted the false invoices to collect the revenue sharing fees, which gave the false appearance that the fees were for consulting when, in fact, they were for revenue sharing arrangements that had not been disclosed. Moreover, these fees were paid to entities that McNamee and Shoemaker apparently created solely for the purpose of receiving fees. Also, McNamee and Shoemaker substantially assisted in the scheme because each knew about the revenue sharing agreements and reviewed the materials provided to Total Wealth clients, but failed to make sure that these arrangements were sufficiently disclosed.

### 3. Total Wealth's Custody Rule Violation

53. As the managing member of Altus Management, which is the general partner of the Altus Funds, Total Wealth had custody of the funds and securities of its clients, the Altus

funds, as well the funds and securities of the investors in those funds who are Total Wealth clients. As such, Total Wealth was required to comply directly with all the requirements of the Custody Rule, 17 C.F.R. §275.206(4)-2, unless it satisfied the requirements of the audit exception, in which case it does not have to comply with Rule 206(4)-(2)(a)(2) (notice to clients) or (a)(3) (account statements to clients) and "will be deemed to have complied" with (a)(4) (independent verification by annual examination). Total Wealth neither complied with the provisions of Rule 206(4)-(2)(a)(4), nor did it satisfy this provision by taking the audit approach provided in 206(4)-2(b)(4), that is by having the Altus Funds audited annually by an independent public accountant who is registered with, and subject to regular inspection by, the PCAOB and by distributing audited financial statements prepared in accordance with GAAP to the Altus investors within 120 days of the end of its fiscal year. 17 C.F.R. §275. 206(4)-2(b)(4)(ii) (audit must be conducted "by an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by the Public Company Accounting Oversight Board in accordance with its rules") (emphasis added).

54. In its ADV filings since March 2011, Total Wealth has claimed that it has complied with the Custody Rule by having the Altus Funds audited annually by the Auditing Firm. Total Wealth also identifies the Auditing Firm as the auditor of the Altus Portfolio Series Funds in the offering memoranda for the funds in this series.

55. These representations are not true. The only audit that the Auditing Firm performed was of the 2010 financial statements of the Altus Capital Opportunity Fund. But the Auditing Firm was not independent of the Altus Capital Opportunity Fund as required by Regulation S-X because the Auditing Firm had prepared the 2010 financial statements for the Altus Capital Opportunity Fund prior to conducting his audit. The Auditing Firm also was not subject to regular inspection by the PCAOB. Thus, Total Wealth could not use that audit to avail itself of the audit exception to the Custody Rule.

56. Cooper and McNamee aided and abetted Total Wealth's Custody Rule violation. Both were the Auditing Firm's principal contacts at Total Wealth during the Auditing Firm's preparation of the 2010 financial statements and the Auditing Firm's audit of those statements. Each knew or was reckless in not knowing that the Auditing Firm was required to be subject to regular inspection by the PCAOB if the Auditing Firm's audits were to be used to satisfy the audit exception to the Custody Rule. As a result, both Cooper and McNamee knew, or were reckless in not knowing, that the Auditing Firm was not conducting annual audits as required by the rule, did not possess the requisite independence, and was not subject to regular PCAOB inspection as required by the Custody Rule. They also provided the Auditing Firm with information that the Auditing Firm used to prepare the Altus Fund financial statements, and reviewed those financial statements. Cooper also signed the management representation letter. Thus, Cooper and McNamee provided substantial assistance to Total Wealth's Custody Rule violations.

## E. VIOLATIONS

57. As a result of the conduct described above, Total Wealth and Cooper willfully violated Sections 206(1), 206(2), 206(4) of the Advisers Act, which prohibit fraudulent conduct

by an investment adviser, and Rule 206(4)-8, promulgated thereunder, by directing client money to funds that paid revenue sharing fees, without adequate disclosure, by engaging in a scheme to collect and conceal their receipt of the revenue sharing fees, and by otherwise misleading clients regarding these fees and their due diligence efforts, each of which breached their respective fiduciary duties in violation of 206(1), 206(2), 206(4) of the Advisers Act and Rule 206(4)-8.

58. As a result of the conduct described above, by failing to obtain independent verification of client funds and securities as set forth in Rule 206(4)-(2)(a), Total Wealth willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-2, promulgated thereunder, which makes it a fraudulent, deceptive or manipulative act under Section 206(4) for any registered investment adviser to have custody of clients' funds or securities in a pooled investment vehicle unless that investment adviser complies with Rule 206(4)-2(a) or with the exceptions set forth in Rule 206(4)-2(b).

59. As a result of the conduct described above, by making misleading and false statements regarding the revenue sharing fees, Total Wealth's custody of client funds, the independence of the Altus Funds' auditor, and the annual audits of the Altus Funds, Total Wealth, Cooper, McNamee, and Shoemaker willfully violated Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission . . . or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

60. As a result of the conduct described above, McNamee and Shoemaker willfully aided and abetted and caused Total Wealth and Cooper's violations of Sections 206(1), 206(2), and 206(4) of the Advisers Act and Rule 206(4)-8.

61. As a result of the conduct described above, Cooper and McNamee willfully aided and abetted and caused Total Wealth's violations of Section 206(4) of the Advisers Act and Rule 206(4)-2.

## IV.

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

Accordingly, pursuant to Section 15(b) of the Securities Exchange Act of 1934, Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940, it is hereby ORDERED that:

A. Respondent McNamee shall cease and desist from committing or causing any violations and any future violations of Sections 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rules 206(4)-2 and 206(4)-8 promulgated thereunder.

B. Respondent Shoemaker shall cease and desist from committing or causing any violations and any future violations of Sections 206(1), 206(2), 206(4) and 207 of the Advisers Act and Rule 206(4)-8 promulgated thereunder.

C. Respondent McNamee 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;

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; 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

with the right to apply for reentry after five (5) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

D. Respondent Shoemaker 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

prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter

with the right to apply for reentry after five (5) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

E. Any reapplication for association by McNamee or Shoemaker 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.

F. Respondent McNamee shall, within 14 days of the entry of this Order, pay disgorgement, which represents profits gained as a result of the conduct described herein, of $103,966 and prejudgment interest of $3,427, for a total of $107,393, to the Securities and Exchange Commission. Respondent McNamee has placed into escrow $30,000, which shall be paid to the Securities and Exchange Commission upon entry of this Order, and that amount shall be credited to the amount owed by Respondent McNamee pursuant to this Order. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. In addition, Respondent McNamee shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of $307,500 to the Securities and Exchange Commission. 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 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 McNamee 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 Lorraine Echavarria, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., 11th Floor, Los Angeles, CA 90036.

G. Respondent Shoemaker shall, within 14 days of the entry of this Order, pay disgorgement, which represents profits gained as a result of the conduct described herein, of $128,180 and prejudgment interest of $4,225, for a total of $132,405, to the Securities and Exchange Commission. Respondent Shoemaker has placed into escrow $50,000, which shall be paid to the Securities and Exchange Commission upon entry of this Order, and that amount shall be credited to the amount owed by Respondent Shoemaker pursuant to this Order. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. In addition, Respondent Shoemaker shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of $300,000 to the Securities and Exchange Commission. 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 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 Shoemaker 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 Lorraine Echavarria, Division of Enforcement, Securities and Exchange Commission, 5670 Wilshire Blvd., 11th Floor, Los Angeles, CA 90036.

H. Any civil money 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, McNamee and Shoemaker agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of their payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, McNamee and Shoemaker agree that they 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 Securities and Exchange Commission. 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 McNamee or Shoemaker by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by McNamee and Shoemaker, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by McNamee or Shoemaker under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

## SECURITIES AND EXCHANGE COMMISSION

**17 CFR Ch. II**

**[Release Nos. 33–9926, 34–75968, IA–4207, IC–31848, File No. S7–17–15]**

## Regulatory Flexibility Agenda

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Semiannual regulatory agenda.

**SUMMARY:** The Securities and Exchange Commission is publishing the Chair's agenda of rulemaking actions pursuant to the Regulatory Flexibility Act (RFA) (Pub. L. 96–354, 94 Stat. 1164) (Sep. 19, 1980). The items listed in the Regulatory Flexibility Agenda for fall 2015, reflect only the priorities of the Chair of the U.S. Securities and Exchange Commission, and do not necessarily reflect the view and priorities of any individual Commissioner.

Information in the agenda was accurate on September 23, 2015, the date on which the Commission's staff completed compilation of the data. To the extent possible, rulemaking actions by the Commission since that date have been reflected in the agenda. The Commission invites questions and public comment on the agenda and on the individual agenda entries.

The Commission is now printing in the **Federal Register**, along with our preamble, only those agenda entries for which we have indicated that preparation of an RFA analysis is required.

The Commission's complete RFA agenda will be available online at *www.reginfo.gov.*

**DATES:** Comments should be received on or before January 14, 2016.

**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 email to *rule-comments@sec.gov.* Please include File Number S7–17–15 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 to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549–1090.

All submissions should refer to File No. S7–17–15. 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 Web site (*http://www.sec.gov/rules/other.shtml*). Comments are also available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

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

**SUPPLEMENTARY INFORMATION:** The RFA requires each Federal agency, twice each year, to publish in the **Federal Register** an agenda identifying rules that the agency expects to consider in the next 12 months that are likely to have a significant economic impact on a substantial number of small entities (5 U.S.C. 602(a)). The RFA specifically provides that publication of the agenda does not preclude an agency from considering or acting on any matter not included in the agenda and that an agency is not required to consider or act on any matter that is included in the agenda (5 U.S.C. 602(d)). The Commission may consider or act on any matter earlier or later than the estimated date provided on the agenda. While the agenda reflects the current intent to complete a number of rulemakings in the next year, the precise dates for each rulemaking at this point are uncertain. Actions that do not have an estimated date are placed in the long-term category; the Commission may nevertheless act on items in that category within the next 12 months. The agenda includes new entries, entries carried over from prior publications, and rulemaking actions that have been completed (or withdrawn) since publication of the last agenda.

The following abbreviations for the acts administered by the Commission are used in the agenda:

"Securities Act"— Securities Act of 1933

"Exchange Act"— Securities Exchange Act of 1934

"Investment Company Act"— Investment Company Act of 1940

"Investment Advisers Act"— Investment Advisers Act of 1940

"Dodd Frank Act"—Dodd-Frank Wall Street Reform and Consumer Protection Act

"JOBS Act"—Jumpstart Our Business Startups Act'

The Commission invites public comment on the agenda and on the individual agenda entries.

By the Commission.

Dated: September 23, 2015.

**Brent J. Fields,**

*Secretary.*

### Division of Corporation Finance—Final Rule Stage

| Sequence No. | Title | Regulation Identifier No. |
|---|---|---|
| 542 | Pay Versus Performance | 3235–AL00 |
| 543 | Crowdfunding | 3235–AL37 |
| 544 | Amendments to Regulation D, Form D and Rule 156 Under the Securities Act | 3235–AL46 |
| 545 | Disclosure of Hedging by Employees, Officers and Directors | 3235–AL49 |
| 546 | Listing Standards for Recovery of Erroneously Awarded Compensation | 3235–AK99 |
| 547 | Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act | 3235–AL40 |

### Division of Investment Management—Proposed Rule Stage

| Sequence No. | Title | Regulation Identifier No. |
|---|---|---|
| 548 | Investment Company Reporting Modernization | 3235–AL42 |

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DIVISION OF INVESTMENT MANAGEMENT—FINAL RULE STAGE

| Sequence No. | Title | Regulation Identifier No. |
|---|---|---|
| 549 | Reporting of Proxy Votes on Executive Compensation and Other Matters | 3235–AK67 |
| 550 | Amendments to Form ADV and Investment Advisers Act Rules | 3235–AL75 |

DIVISION OF TRADING AND MARKETS—LONG-TERM ACTIONS

| Sequence No. | Title | Regulation Identifier No. |
|---|---|---|
| 551 | Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934 | 3235–AL14 |

## SECURITIES AND EXCHANGE COMMISSION (SEC)

*Division of Corporation Finance*

Final Rule Stage

### 542. Pay Versus Performance

*Legal Authority:* Pub. L. 111–203, sec 955; 15 U.S.C. 78n

*Abstract:* The Commission proposed rules to implement section 953(a) of the Dodd Frank Act, which added section 14(i) to the Exchange Act to require issuers to disclose information that shows the relationship between executive compensation actually paid and the financial performance of the issuer.

*Timetable:*

| Action | Date | FR Cite |
|---|---|---|
| NPRM | 05/07/15 | 80 FR 26330 |
| NPRM Comment Period End. | 07/06/15 | |
| Final Action | 10/00/16 | |

*Regulatory Flexibility Analysis Required:* Yes.

*Agency Contact:* Eduardo Aleman, Division of Corporation Finance, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549, *Phone:* 202 551–3430, *Fax:* 202 772–9207.

*RIN:* 3235–AL00

### 543. Crowdfunding

*Legal Authority:* 15 U.S.C. 77a *et seq.*; 15 U.S.C. 78a *et seq.*; Pub. L. 112–108, secs 301 to 305

*Abstract:* The Commission adopted rules to implement title III of the JOBS Act by prescribing rules governing the offer and sale of securities through crowdfunding under new section 4(a)(6) of the Securities Act.

*Timetable:*

| Action | Date | FR Cite |
|---|---|---|
| NPRM | 11/05/13 | 78 FR 66428 |
| NPRM Comment Period End. | 02/03/14 | |
| Final Action | 10/00/16 | |

*Regulatory Flexibility Analysis Required:* Yes.

*Agency Contact:* Timothy White, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549, *Phone:* 202 551–7232.

Sebastian Gomez Abero, Division of Corporation Finance, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549, *Phone:* 202 551–3460.

*RIN:* 3235–AL37

### 544. Amendments to Regulation D, Form D and Rule 156 Under the Securities Act

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

*Abstract:* The Commission proposed rule and form amendments to enhance the Commission's ability to evaluate the development of market practices in offerings under Rule 506 of Regulation D and 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.

*Timetable:*

| Action | Date | FR Cite |
|---|---|---|
| NPRM | 07/24/13 | 78 FR 44806 |
| NPRM Comment Period End. | 09/23/13 | |
| NPRM Comment Period Reopened. | 10/03/13 | 78 FR 61222 |
| NPRM Comment Period End. | 11/04/13 | |
| Final Action | 10/00/16 | |

*Regulatory Flexibility Analysis Required:* Yes.

*Agency Contact:* Mark Vilardo, Division of Corporation Finance, Securities and Exchange Commission, 100 F St. NE., Washington, DC 20549, *Phone:* 202 551–3500.

*RIN:* 3235–AL46

### 545. Disclosure of Hedging by Employees, Officers and Directors

*Legal Authority:* Pub. L. 111–203

*Abstract:* The Commission proposed rules to implement section 955 of the Dodd Frank Act, which added section 14(j) to the Exchange Act to require annual meeting proxy statement disclosure of whether employees or members of the board of directors are permitted to engage in transactions to hedge or offset any decrease in the market value of equity securities granted to the employee or board member as compensation, or held directly or indirectly by the employee or board member.

*Timetable:*

| Action | Date | FR Cite |
|---|---|---|
| NPRM | 02/17/15 | 80 FR 8486 |
| Final Action | 10/00/16 | |

*Regulatory Flexibility Analysis Required:* Yes.

*Agency Contact:* Carolyn Sherman, Division of Corporation Finance, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549, *Phone:* 202 551–3500.

*RIN:* 3235–AL49

### 546. Listing Standards for Recovery of Erroneously Awarded Compensation

*Legal Authority:* Pub. L. 111–203, sec 954; 15 U.S.C. 78j–4

*Abstract:* The Commission proposed rules to implement section 954 of the Dodd Frank Act, which requires the Commission to adopt rules to direct national securities exchanges to prohibit the listing of securities of issuers that have not developed and implemented a policy providing for disclosure of the issuer's policy on incentive-based compensation and mandating the clawback of such compensation in certain circumstances.

*Timetable:*

| Action | Date | FR Cite |
|---|---|---|
| NPRM | 07/14/15 | 80 FR 41144 |

| Action | Date | FR Cite |
|---|---|---|
| NPRM Comment Period End. | 09/14/15 | |
| Final Action ......... | 10/00/16 | |

*Regulatory Flexibility Analysis Required:* Yes.

*Agency Contact:* Anne M. Krauskopf, Division of Corporation Finance, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549, *Phone:* 202 551–3500.

*RIN:* 3235–AK99

**547. Changes to Exchange Act Registration Requirements To Implement Title V and Title VI of the JOBS Act**

*Legal Authority:* Pub. L. 112–106

*Abstract:* The Commission proposed amendments to rules to implement titles V (Private Company Flexibility and Growth) and VI (Capital Expansion) of the JOBS Act.

*Timetable:*

| Action | Date | FR Cite |
|---|---|---|
| NPRM .................. | 12/30/14 | 79 FR 78343 |
| NPRM Comment Period End. | 03/03/15 | |
| Final Action ......... | 10/00/16 | |

*Regulatory Flexibility Analysis Required:* Yes.

*Agency Contact:* Steven G. Hearne, Division of Corporation Finance, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549, *Phone:* 202 551–3430.

*RIN:* 3235–AL40

## SECURITIES AND EXCHANGE COMMISSION (SEC)

*Division of Investment Management*

Proposed Rule Stage

**548. Investment Company Reporting Modernization**

*Legal Authority:* 15 U.S.C. 77 *et seq.*; 15 U.S.C. 77aaa *et seq.*; 15 U.S.C. 78a *et seq.*; 15 U.S.C. 80a *et seq.*; 44 U.S.C. 3506; 44 U.S.C. 3507

*Abstract:* The Commission proposed new rules and forms as well as amendments to its rules and forms to modernize the reporting and disclosure of information by registered investment companies.

*Timetable:*

| Action | Date | FR Cite |
|---|---|---|
| NPRM .................. | 06/12/15 | 80 FR 33590 |
| NPRM Comment Period End. | 08/11/15 | |
| NPRM Comment Period Re-opened. | 10/12/15 | 80 FR 62274 |
| NPRM Comment Period Re-opened End. | 01/13/16 | |
| Final Action ......... | 10/00/16 | |

*Regulatory Flexibility Analysis Required:* Yes.

*Agency Contact:* Sara Cortes, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549, *Phone:* 202 551–6781, *Email: cortess@sec.gov.*

*RIN:* 3235–AL42

## SECURITIES AND EXCHANGE COMMISSION (SEC)

*Division of Investment Management*

Final Rule Stage

**549. Reporting of Proxy Votes on Executive Compensation and Other Matters**

*Legal Authority:* 15 U.S.C. 78m; 15 U.S.C. 78w(a); 15 U.S.C. 78mm; 15 U.S.C. 78x; 15 U.S.C. 80a–8; 15 U.S.C. 80a–29; 15 U.S.C. 80a–30; 15 U.S.C. 80a–37; 15 U.S.C. 80a–44; Pub. L. 111–203, sec 951

*Abstract:* The Commission proposed rule amendments to implement section 951 of the Dodd Frank Act. The proposed amendments to rules and Form N–PX would require institutional investment managers subject to section 13(f) of the Exchange Act to report how they voted on any shareholder vote on executive compensation or golden parachutes pursuant to sections 14A(a) and (b) of the Exchange Act.

*Timetable:*

| Action | Date | FR Cite |
|---|---|---|
| NPRM .................. | 10/28/10 | 75 FR 66622 |
| NPRM Comment Period End. | 11/18/10 | |
| Final Action ......... | 10/00/16 | |

*Regulatory Flexibility Analysis Required:* Yes.

*Agency Contact:* Matthew DeLesDernier, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549, *Phone:* 202 551–6792, *Email: delesdernierj@sec.gov.*

*RIN:* 3235–AK67

**550. • Amendments to Form ADV and Investment Advisers Act Rules**

*Legal Authority:* 15 U.S.C. 77s(a); 15 U.S.C. 77sss(a); 15 U.S.C. 78bb(e)(2); 15 U.S.C. 78w(a); 15 U.S.C. 80a–37(a); 15 U.S.C. 80b–3(c)(1)

*Abstract:* The Commission proposed amendments to Form ADV that are designed to provide additional information regarding advisers, including information about their separately managed account business; incorporate a method for private fund adviser entities operating a single advisory business to register using a single Form ADV; and make clarifying, technical and other amendments to certain Form ADV items and instructions. The Commission also proposed amendments to the Investment Advisers Act books and records rule and technical amendments to several Investment Advisers Act rules to remove transition provisions that are no longer necessary.

*Timetable:*

| Action | Date | FR Cite |
|---|---|---|
| NPRM .................. | 06/12/15 | 80 FR 33718 |
| NPRM Comment Period End. | 08/11/15 | |
| Final Action ......... | 10/00/16 | |

*Regulatory Flexibility Analysis Required:* Yes.

*Agency Contact:* Holly Hunter-Ceci, Division of Investment Management, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549, *Phone:* 202 551–6869, *Email: hunter-cecih@sec.gov.*

*RIN:* 3235–AL75

## SECURITIES AND EXCHANGE COMMISSION (SEC)

*Division of Trading and Markets*

Long-Term Actions

**551. Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934**

*Legal Authority:* Pub. L. 111–203, sec 939A

*Abstract:* Section 939A of the Dodd Frank Act requires the Commission to remove certain references to credit ratings from its regulations and to substitute such standards of creditworthiness as the Commission determines to be appropriate. The Commission amended certain rules and one form under the Exchange Act applicable to broker-dealer financial responsibility, and confirmation of transactions. The Commission has not yet finalized amendments to certain rules regarding the distribution of securities.

*Timetable:*

| Action | Date | FR Cite |
|---|---|---|
| NPRM ................. | 05/06/11 | 76 FR 26550 |
| NPRM Comment Period End. | 07/05/11 | |
| Final Action ......... | 01/08/14 | 79 FR 1522 |
| Final Action Effective. | 07/07/14 | |

| Action | Date | FR Cite |
|---|---|---|
| Next Action Undetermined. | To Be Determined | |

*Regulatory Flexibility Analysis Required:* Yes.

*Agency Contact:* John Guidroz, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549, *Phone:* 202 551–6439, *Email: guidrozj@sec.gov.*

*RIN:* 3235–AL14

[FR Doc. 2015–30678 Filed 12–14–15; 8:45 am]

BILLING CODE 8011–01–P

**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76679 / December 17, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17006**

| | |
|---|---|
| **In the Matter of**<br><br>**Dewpoint Environmental, Inc.,**<br>**DLR Funding, Inc.,**<br>**Earth Energy Reserves, Inc.,**<br>**ELF Inc.,**<br>**Expect the Best, Inc., and**<br>**First Omega of Louisiana, Inc.,**<br><br>**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 Dewpoint Environmental, Inc., DLR Funding, Inc., Earth Energy Reserves, Inc., ELF Inc., Expect the Best, Inc., and First Omega of Louisiana, Inc.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Dewpoint Environmental, Inc. (CIK No. 1317840) is a void Delaware corporation located in Austin, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Dewpoint Environmental is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-KSB for the period ended January 31, 2007, which reported a net loss of $1,675 for the prior twelve months.

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2. DLR Funding, Inc. (CIK No. 1026507) is a revoked Nevada corporation located in Windsor, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DLR Funding 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, 2007, which reported a net loss of $4,260,000 for the prior twelve months.

3. Earth Energy Reserves, Inc. (CIK No. 1327557) is a Nevada corporation located in Estes Park, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Earth Energy Reserves 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, 2012, which reported a net loss of $2,265,563 for the prior nine months.

4. ELF Inc. (CIK No. 1176188) is a delinquent Colorado corporation located in Littleton, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ELF 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 January 31, 2003, which reported a net loss of $2,881 for the prior nine months.

5. Expect the Best, Inc. (CIK No. 1120816) is a dissolved Colorado corporation located in Colorado Springs, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Expect the Best is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed its registration statement on August 4, 2000.

6. First Omega of Louisiana, Inc. (CIK No. 1050109) is an inactive Louisiana corporation located in Houston, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). First Omega of Louisiana is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10 registration statement on November 19, 1997.

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/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'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.

Brent J. Fields
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. 76735 / December 22, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17019**

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|---|---|
| **In the Matter of**<br><br>**USChina Venture I, Inc., and**<br>**USChina Venture II, Inc.,**<br><br>**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 USChina Venture I, Inc. and USChina Venture II, Inc.

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. USChina Venture I, Inc. (CIK No. 1510961) is a revoked Nevada corporation located in New Haven, Connecticut with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). USChina Venture I is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 2012, which reported a net loss of $2,500 from the company's December 28, 2010 inception to December 31, 2012.

2. USChina Venture II, Inc. (CIK No. 1510962) is a revoked Nevada corporation located in New Haven, Connecticut with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). USChina Venture II is delinquent

in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 2012, which reported a net loss of $2,500 from the company's December 28, 2010 inception to December 31, 2012.

B. DELINQUENT PERIODIC FILINGS

3. 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.

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

5. 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.

Brent J. Fields
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. 76795 / December 30, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-17033

| | |
|---|---|
| In the Matter of<br><br>DE Acquisition 7, Inc.,<br>DE Acquisition 8, Inc.,<br>DE Acquisition 9, Inc.,<br>DE Acquisition 10, Inc., and<br>DE Acquisition 12, Inc.,<br><br>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 DE Acquisition 7, Inc., DE Acquisition 8, Inc., DE Acquisition 9, Inc., DE Acquisition 10, Inc., and DE Acquisition 12, Inc.

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. DE Acquisition 7, Inc. (CIK No. 1514403) is a void Delaware corporation located in The Woodlands, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DE Acquisition 7 is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended November 30, 2012, which reported a net loss of $6,745 from the company's January 25, 2011 inception to November 30, 2012.

2. DE Acquisition 8, Inc. (CIK No. 1514404) is a void Delaware corporation located in The Woodlands, Texas with a class of securities registered with the

8 of 9

Commission pursuant to Exchange Act Section 12(g). DE Acquisition 8 is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended November 30, 2012, which reported a net loss of $6,745 from the company's January 25, 2011 inception to November 30, 2012.

3. DE Acquisition 9, Inc. (CIK No. 1514373) is a void Delaware corporation located in The Woodlands, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DE Acquisition 9 is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended November 30, 2012, which reported a net loss of $6,745 from the company's January 25, 2011 inception to November 30, 2012.

4. DE Acquisition 10, Inc. (CIK No. 1514372) is a void Delaware corporation located in The Woodlands, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DE Acquisition 10 is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended November 30, 2012, which reported a net loss of $6,745 from the company's January 25, 2011 inception to November 30, 2012.

5. DE Acquisition 12, Inc. (CIK No. 1514370) is a void Delaware corporation located in The Woodlands, Texas with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). DE Acquisition 12 is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended November 30, 2012, which reported a net loss of $6,745 from the company's January 25, 2011 inception to November 30, 2012.

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.

Brent J. Fields
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. 76794 / December 30, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17032**

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| **In the Matter of**<br><br>**Buncombe, Inc.,**<br>**Cotton Bay Holdings, Inc.,**<br>**Middlesex Inc., and**<br>**REON Holdings, Inc.,**<br><br>**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 Buncombe, Inc., Cotton Bay Holdings, Inc., Middlesex Inc., and REON Holdings, Inc.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Buncombe, Inc. (CIK No. 1554240) is a defaulted Nevada corporation located in Chapel Hill, North Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Buncombe is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended January 31, 2013, which reported a net loss of $28,028 from the company's April 27, 2012 inception to January 31, 2013.

2. Cotton Bay Holdings, Inc. (CIK No. 1111468) is a Delaware corporation located in Fort Lauderdale, Florida with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Cotton Bay Holdings is delinquent

in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended June 30, 2012, which reported a net loss of $87,981 from the company's August 20, 1997 inception to June 30, 2012.

3. Middlesex Inc. (CIK No. 1554238) is a revoked Nevada corporation located in Chapel Hill, North Carolina with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Middlesex is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended January 31, 2013, which reported a net loss of $27,848 from the company's April 27, 2012 inception to January 31, 2013.

4. REON Holdings, Inc. (CIK No. 1554241) is a revoked Nevada corporation located in Beijing, China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). REON Holdings is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended January 31, 2013, which reported a net loss of $24,206 from the company's April 27, 2012 inception to January 31, 2013.

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.

Brent J. Fields
Secretary

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

美利坚合众国

证券交易委员会主持

《1934 年证券交易法》

发布号 76794 / December 30, 2015

行政程序

文件号 3-17032

| | |
|---|---|
| 关于<br><br>Buncombe 公司<br>棉花湾控股公司<br>Middlesex 公司和<br>睿安财富公司<br><br>各被告方。 | 根据《1934 年证券交易法》第 12(j)节规定建立行政程序的命令及举办听证会的通知 |

一.

证券交易委员会 ("委员会") 认为为保护投资者，根据《1934 年证券交易法》("交易法") 12(j)节规定对被告 Buncombe 公司、棉花湾控股公司、Middlesex 公司和睿安财富公司建立公共行政程序是必要且适当的。

二.

经过调查，执行部宣称：

A. 各被告方

1. Buncombe 公司 (CIK 号 1554240) 为一家拖欠款项、设在北卡罗来纳州教会山市(Chapel Hill, North Carolina) 的内华达公司。它根据《交易法》第 12(g)节规

9 of 9

定在委员会进行了证券类别注册。 Buncombe 公司没有定期向委员会递交报告。该公司自从递交了截止于 2013 年 1 月 31 日的 10-Q 表后未曾递交过任何定期报告。该表报告说，从 2012 年 4 月 27 日公司建立至 2013 年 1 月 31 日，该公司净亏损 28,028 美元。

2. 棉花湾控股公司 (CIK 号 1111468) 是一家设在佛罗里达州劳德代尔堡 (Fort Lauderdale, Florida) 的德拉瓦公司。它根据《交易法》第 12(g)节规定在委员会进行了证券类别注册。棉花湾控股公司没有定期向委员会递交报告。该公司自从递交了截止于 2012 年 6 月 30 日的 10-Q 表后未曾递交过任何定期报告。该表报告说，从 1997 年 8 月 20 日公司建立至 2012 年 6 月 30 日，该公司净亏损 87,981 美元。

3. Middlesex 公司(CIK 号 1554238) 是一家已被撤销的、设在北卡州教会山市的内华达公司。它根据《交易法》第 12(g)节规定在委员会进行了证券类别注册。Middlesex 公司没有定期向委员会递交报告。该公司自从递交了截止于 2013 年 1 月 31 日的 10-Q 表后未曾递交过任何定期报告。该表报告说，从 2012 年 4 月 27 日公司建立至 2013 年 1 月 31 日，该公司净亏损 27,848 美元。

4. 睿安财富公司 (CIK 号 1554241) 是一家已被撤销的、设在中国北京的内华达公司。它根据《交易法》第 12(g)节规定在委员会进行了证券类别注册。睿安财富公司没有定期向委员会递交报告。该公司自从递交了截止于 2013 年 1 月 31 日的 10-Q 表后未曾递交过任何定期报告。该表报告说，从 2012 年 4 月 27 日公司建立至 2013 年 1 月 31 日，该公司净亏损 24,206 美元。

B. 没有定期提交报告

5. 正如上文详述，所有被告都没有定期向委员会递交报告，屡次未履行其应及时递交定期报告的义务，并且忽视企业金融部向其发出的、要求其遵守递交定期报告义务的违规信，或者因其未遵守委员会关于在委员会留下有效地址的规定而没有收到这些信函。

6. 《交易法》第 13 (a) 节及随后颁布的其它规则明文规定，根据《交易法》第 12 节注册的证券发行公司必须向委员会递交当前的、具有准确信息的定期

报告，即使注册是按照 12(g) 规定自发形成的。具体说来，13a-1 条规定要求证券发行公司递交年度报告，13a-13 条规定要求国内的证券发行公司递交季度报告。

7. 基于上述内容，被告未遵守《交易法》第 13 (a) 节规定及随后颁布的 13a-1 条和/或 13a-13 条规定。

三.

根据执行部提出的指控，委员会认为为保护投资者，建立公共行政程序是必要且适当的，从而确定：

A. 本文第二部分包含的指控是否属实以及与此相关的，是否向被告提供对这些指控做出辩护的机会；和

B. 为保护投资者，暂停（不超过 12 个月）或撤销在本文第二部分中提到的的被告、符合《交易法》12b-2 条或 12g-3 条规则的任何继承人以及被告任何新公司按照《交易法》第 12 节规定注册的每个证券类别是否是必要且适当的。

四.

兹命令为对本文第三部分所述问题进行取证，应在指定时间和地点举行公开听证会。按照委员会《实务规则》（Rules of Practice）第 110 条[《联邦法规》第 17 卷第 201.110 节]规定，听证会应由进一步命令指定的行政法官主持。

兹进一步命令被告应按照委员会《实务规则》第 220(b)条[《联邦法规》第 17 卷第 201.220(b)节]规定在本命令送达后十 (10) 天内对本命令中包含的指控递交答辩。

3 按照委员会《实务规则》第 155(a)条、第 220(f)条、第 221(f)条和第 310 条[《联邦法规》第 17 卷第 201.155(a)、201.220(f)、201.221(f)和 201.310 节]规定，如果被告没有递交指定的答辩或者在得到及时通知后没有出现在听证会上，那么被告、符合《交易法》第 12b-2 或 12g-3 规定的任何继承人以及被告名下的任何新公司有可能被视为失职方，根据本命令确定的程序可能会对其不利，，且提出的各项指控有可能被视为属实。

本命令应当面或通过挂号信、快递邮件以及委员会《实务规则》允许的其它方式送至被告处。

兹进一步命令，行政法官应根据委员会《实务规则》第 360(a)(2)节[《联邦法规》第 17 卷第 201.360(a)(2)节]规定，在本命令送达日后 120 天内作出初步判决。

在无适当豁免情况下，参与本程序或任何事实上和本程序相关的调查行动或起诉工作的委员会任何官员或员工不得参与本事宜的判决或提出建议，除非根据通知规定该官员或员工担任程序的证人或律师。由于本程序不属于《行政程序法》第 551 节定义的“制定规则”，其不应受 553 节规定的限制，因此无须延迟委员会任何最终判决的生效日期。

委员会命令。

Brent J. Fields 书记员

SECURITIES AND EXCHANGE COMMISSION

This file is maintained pursuant to the Freedom of Information Act (5 U.S.C. 552). It contains a copy of each decision, order, rule or similar action of the Commission, for **December 2015**, with respect to which the final votes of individual Members of the Commission are required to be made available for public inspection pursuant to the provisions of that Act.

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

MARY JO WHITE, CHAIR

LUIS A. AGUILAR, COMMISSIONER

KARA M. STEIN, COMMISSIONER

MICHAEL S. PIWOWAR, COMMISSIONER

(74 Documents)

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 76533 / December 1, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-12868

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| In the Matter of<br><br>PACKETPORT.COM, INC.,<br>RONALD DURANDO,<br>MICROPHASE CORP.,<br>ROBERT H. JAFFE,<br>GUSTAVE DOTOLI,<br>M. CHRISTOPHER AGARWAL,<br>and THEODORE KUNZOG,<br><br>Respondents. | ORDER APPROVING APPLICATION OF FUND ADMINISTRATOR FOR PAYMENT OF FEES AND EXPENSES |

On October 18, 2007, the Securities and Exchange Commission ("Commission") issued an Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934 ("Order")[1] against two corporations, PacketPort.com, Inc. and Microphase Corp. ("Microphase"), and five individuals, Ronald Durando ("Durando"), Robert H. Jaffe ("Jaffe"), Gustave Dotoli ("Dotoli"), M. Christopher Agarwal, and Theodore Kunzog (collectively, "Respondents"), for violations of the federal securities laws in connection with a pump and dump scheme. Among other things, the Commission ordered Respondents Microphase, Durando, Dotoli, and Jaffe to pay disgorgement totaling $1,075,000 to the Commission. The disgorgement obligation was fully paid as

[1] Securities Act Rel. No. 8858 (Oct. 18, 2007).

of October 15, 2008. The disgorgement paid by these Respondents, plus any accumulated interest earned, less any taxes, fees, or expenses incurred in the administration of the Final Plan of Distribution ("Plan"), constitutes the disgorgement fund ("Disgorgement Fund").

On October 6, 2011, the Commission issued an Order appointing Rust Consulting, Inc. ("Rust") as the Fund Administrator and setting the bond amount at $1,075,000.[2] On the same day, the Commission published the Notice of Proposed Plan of Distribution and Opportunity for Comment ("Notice").[3] No comments were received in response to the Notice. On December 12, 2011, the Commission issued an Order Approving Distribution Plan.[4]

The Plan provides that the Fund Administrator shall be entitled to reasonable fees in accordance with the cost proposal submitted to the Commission and shall be entitled to reimbursement for reasonable costs and expenses from the Disgorgement Fund. The fees and expenses for the administration of the Disgorgement Fund will be paid first from interest earned on the invested funds, then, if not sufficient, from the corpus. The Plan further required that the Fund Administrator obtain the required bond in the amount of $1,075,000, and provided that the cost of the bond will be paid first from interest earned on the invested funds, then, if not sufficient, from the corpus.

The Fund Administrator has submitted an invoice totaling $146,520.61 to Commission staff that covers the period from its appointment on October 6, 2011 to September 30, 2013. The Commission staff has reviewed the Fund Administrator's invoice, confirms that the services have been provided, and finds the fees and expenses of $146,520.61 to be reasonable and in accordance with the Plan. The Commission staff has requested that the Commission authorize the Office of Financial Management

[2] Exchange Act Rel. No. 65498 (Oct. 6, 2011).
[3] Exchange Act Rel. No. 65490 (Oct. 6, 2011).
[4] Exchange Act Rel. No. 65936 (Dec. 12, 2011).

("OFM") to pay the Fund Administrator's invoiced fees and expenses of $146,520.61 from the Disgorgement Fund, and in addition to authorize OFM to pay, at the direction of the Division of Enforcement's Assistant Director of the Office of Distributions, Logistics, and Services ("Assistant Director"), the Fund Administrator's future fees and expenses up to, but not to exceed, $25,000 per monthly invoice, so long as the total amount paid to the Fund Administrator as of the date of the invoice to be paid does not exceed the total amount of the cost proposal submitted by the Fund Administrator by more than $5,000.

Accordingly, it is hereby ORDERED, pursuant to Rule 1105(d) of the Commission's Rules on Fair Fund and Disgorgement Plans, 17 C.F.R. § 201.1105(d), that OFM pay the Fund Administrator's fees and expenses in the amount of $146,520.61. Further, OFM is authorized to pay, at the direction of the Assistant Director, any future fees and expenses up to, but not to exceed, $25,000 per monthly invoice, so long as the total amount paid to the Fund Administrator, as of the date of the invoice to be paid, does not exceed the total amount of the cost proposal submitted by the Fund Administrator by more than $5,000.

By the Commission.

Brent J. Fields
Secretary

By: Lynn M. Powalski
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT of 1934
Release No. 76534 / December 1, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-13532

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| In the Matter of<br><br>Prime Capital Services, Inc.,<br>Gilman Ciocia, Inc.,<br>Michael P. Ryan,<br>Rose M. Rudden,<br>Christie A. Andersen,<br>Eric J. Brown,<br>Matthew J. Collins,<br>Kevin J. Walsh,<br>Mark W. Wells,<br><br>Respondents. | ORDER AUTHORIZING THE TRANSFER OF REMAINING FUNDS AND ANY FUNDS RETURNED TO THE FAIR FUND IN THE FUTURE TO THE U.S. TREASURY, DISCHARGING THE FUND ADMINISTRATOR, AND TERMINATING THE FAIR FUND |

On March 16, 2010, the Securities and Exchange Commission (the "Commission") issued an Order Making Findings and Imposing Remedial Sanctions Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act of 1934 as to Prime Capital Services, Inc. and Gilman Ciocia, Inc. (Securities Act Release No. 9113 (Mar. 16, 2010)) (the "Order"). The Commission found that from 1999 through early 2007, four representatives associated with Prime Capital Services, Inc. ("PCS") who were employed by Gilman Ciocia, Inc. ("G&C") induced senior citizen customers in south Florida into purchasing variable annuities by means of material misrepresentations and omissions. The Commission further found that PCS and several supervisors failed reasonably to supervise the four registered representatives so as to detect and prevent their violations of the federal securities laws. PCS was ordered to pay total of $144,262.58 in disgorgement and prejudgment interest to the Commission, and G&C was ordered to pay total of $450,001 in disgorgement and civil penalties to the Commission. A total of $602,753.96 was paid to the Commission.[1] The Commission created a Fair Fund pursuant to Section 308 of the Sarbanes-Oxley Act of 2002 for these

[1] This amount includes approximately $8,500 in post-order interest paid by G&C.

payments (the "Fair Fund"). The Fair Fund was held in a non-interest bearing account with the United States Department of the Treasury ("U.S. Treasury").

On September 23, 2010, the Commission issued a Notice of Proposed Plan of Distribution and Opportunity for Comment pursuant to Rule 1103 of the Commission's Rules on Fair Fund and Disgorgement Plans ("Commission's Rules"), 17 C.F.R. § 201.1103 (Exchange Act Rel. No. 62979 (September 23, 2010)). Subsequently, on February 1, 2011, the Commission issued a Notice of Proposed Modified Plan of Distribution and Opportunity for Comment pursuant to the same rule (Exchange Act Rel. No. 63813 (February 1, 2011)). On March 14, 2011, the Commission issued an Order Approving Distribution Plan of a Fair Fund and Appointing a Fund Administrator, whereby Robert J. Keyes, a Commission employee, was appointed as Fund Administrator (Exchange Act Rel. No. 64081 (March 14, 2011)).

The Plan of Distribution ("Plan") provided that monies from the Fair Fund would be distributed to Eligible Investors who were harmed by the conduct of PCS and G&C. On May 8, 2012, the Commission issued an Order Approving and Ratifying Prior Disbursement of $390,054.77 to eleven Eligible Investors who paid fees and charges associated with their variable annuity investment and who were described in the Order and/or who testified about their investment experience at an administrative hearing (Exchange Act Release No. 66947 (May 8, 2012)). On December 18, 2013, the Commission issued an Order Directing Disbursement of Fair Fund Residual in the amount of $141,500 to seven Eligible Investors pursuant to Sections 21(d) and 21B(e) of the Securities Exchange Act of 1934. All disbursements were accepted by the Eligible Investors and no amounts were returned to the Fair Fund. In addition, the Fair Fund paid $1,200 in District of Columbia taxes, and $19,829.36 in Tax Administrator fees and expenses. A balance of $50,169.83 remains in the Fair Fund.

The Plan provides that the Fair Fund shall be eligible for termination after all of the following have occurred: 1) the final accounting by the Fund Administrator has been submitted and approved by the Commission; 2) all taxes, fees, and expenses have been paid; and 3) all remaining funds or any residual funds have been received by the Commission. A final accounting, which was submitted to the Commission for approval as required by Rule 1105(f) of the Commission's Rules, 17 C.F.R. § 201.1105(f) and as set forth in the Plan, is now approved. Staff has verified that all taxes, fees and expenses have been paid, and the Commission is in possession of the remaining funds.

Accordingly, IT IS ORDERED that:

A. The remaining Fair Fund balance of $50,169.83, and any funds returned to the Fair Fund in the future, shall be transferred to the U.S. Treasury;

B. The Fund Administrator, Robert J. Keyes, is discharged; and

C. The Fair Fund is terminated.

By the Commission.

Brent J. Fields
Secretary

By: Lynn M. Powalski
Deputy Secretary

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UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 76537 / December 2, 2015

ACCOUNTING AND AUDITING ENFORCEMENT
Release No. 3719 / December 2, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16977

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| In the Matter of<br><br>Melissa K. Koeppel, CPA, and<br>Jeffrey J. Robinson, CPA,<br><br>Respondents. | **ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER** |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice[2] against Melissa K. Koeppel, CPA ("Koeppel") and Jeffrey J. Robinson, CPA ("Robinson") (collectively, "Respondents").

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[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (2) . . . to have engaged in unethical or improper professional conduct.

[2] Rule 102(e)(1) provides, in relevant part:

> The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found . . .
>
> * * *
>
> (ii) to have engaged in unethical or improper professional conduct.

## II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") that the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which is admitted, and except as provided herein in Section V, Respondents consent to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934, and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (the "Order"), as set forth below.

## III.

On the basis of this Order and Respondent's Offers, the Commission finds[3] that:

### A. SUMMARY

1. This matter involves improper professional conduct by (a) Koeppel while serving as the engagement partner for two clients of Grant Thornton, LLP ("Grant Thornton): Assisted Living Concepts, Inc. ("ALC"), a publicly traded senior living company, and Broadwind Energy, Inc. ("Broadwind"), a publicly traded alternative energy company; (b) Robinson while later serving as the engagement partner for ALC. During the course of those engagements, Koeppel and Robinson repeatedly violated professional standards while ignoring numerous red flags and

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* * *

> (iv) with respect to persons licensed to practice as accountants, "improper professional conduct" under Rule 102(e)(1)(ii) means:
>
> * * *
>
> (B) either of the following two types of negligent conduct:
>
> > (1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
> >
> > (2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

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

fraud risks that allowed ALC and Broadwind to file numerous reports with the Commission that were materially false and misleading.

2. For the ALC engagement, for more than three years, Koeppel and Robinson failed to identify a fraud perpetrated by ALC's CEO and CFO. That long-running fraud was designed to mask ALC's defaults on certain occupancy and revenue covenants that had significant financial consequences for ALC in the event of non-compliance. As a result of the fraud and the failed audits, for three years ALC falsely represented to its investors that it was meeting the covenants and avoiding the serious ramifications of the defaults.

3. For the Broadwind engagement, Koeppel's failure to exercise due professional care and skepticism contributed to Broadwind improperly omitting from its financial statements that it had sustained a $58 million impairment charge caused by the severe deterioration of customer relationships for two of Broadwind's most important customers. Koeppel's failures also contributed to Broadwind conducting a public offering for its stock which concealed this impairment charge from investors. Koeppel's negligence further contributed to Broadwind filing multiple financial statements which materially overstated revenue to Broadwind's investors.

## B. RESPONDENTS

4. **Koeppel**, age 54, is a Certified Public Accountant ("CPA") licensed to practice in Wisconsin. Koeppel served as the managing partner of Grant Thornton's Wisconsin practice from 2008 through April 2011. Koeppel served as the Grant Thornton engagement partner on, and had final audit responsibility over, the ALC engagements from 2006 through 2010 and the Broadwind engagements from 2007 through the second quarter of 2010. Since 2012, Koeppel has been employed by Grant Thornton as a managing director, outside the audit-services practice.

5. **Robinson**, age 63, is a CPA licensed to practice in Illinois and Wisconsin. Robinson served as the managing partner of Grant Thornton's Wisconsin practice from April 2011 through July 2015, when he retired. Robinson served as the Grant Thornton engagement partner on, and had final audit responsibility over, the ALC engagements from 2011 through the first quarter of 2013, when ALC terminated its relationship with Grant Thornton upon ALC's acquisition by another company.

## C. OTHER RELEVANT ENTITIES

6. **Grant Thornton** is an Illinois limited liability partnership and a PCAOB-registered public accounting firm with its headquarters in Chicago, Illinois. The conduct at issue occurred in the course of audits and reviews of clients of Grant Thornton's Wisconsin practice.

7. **ALC** was a Nevada corporation with its principal place of business in Menomonee Falls, Wisconsin. Between November 2006 and July 2013, ALC's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange. In February 2013, ALC agreed to be sold to a global private equity firm. In July 2013, when the sale was completed, ALC's stock ceased trading on the NYSE.

8. **Broadwind** is an alternative energy company incorporated in Delaware and headquartered in Cicero, Illinois. In October 2007, Broadwind purchased Brad Foote Gear Works, Inc. ("Brad Foote") to provide gear systems for the wind turbine and other energy industries. Broadwind's common stock was quoted on the OTC Bulletin Board until April 9, 2009, when its common stock began trading on the NASDAQ Global Select Market. Broadwind's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act. On February 5, 2015, the Commission filed a settled action in the Northern District of Illinois against Broadwind and its former CEO and CFO for Broadwind's failure to record and disclose a $58 million impairment charge prior to a public offering in January 2010. The SEC also charged Broadwind and its officers with violations arising from accelerated revenue recognition practices and inadequate disclosures ahead of the offering. Broadwind consented to a judgment enjoining it from violating Section 17(a)(2) of the Securities Act and 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 imposing a civil penalty of $1 million. The former CEO and CFO also consented to a judgement that enjoined them from future securities laws violations, and imposed disgorgement, prejudgment interest, and civil penalties. The district court entered the proposed judgments associated with the settlement on February 11, 2015. *See SEC v. Broadwind Energy, Inc., et al.*, Case No. 15-cv-1142 (N.D. Ill.).

## D. THE AUDITS AND REVIEWS OF ALC

### 1. ALC and the Ventas Lease

9. During the relevant time period, ALC operated more than 200 senior living residences in the United States, totaling more than 9,000 units. On January 1, 2008, ALC purchased the operations of eight assisted living facilities for a total of 540 units in Alabama, Florida, Georgia, and South Carolina (the "Ventas facilities") and simultaneously entered into a lease with Ventas, Inc. ("Ventas"), a publicly traded real estate investment trust ("REIT") and the owner of the facilities, to operate the facilities (the "Ventas lease").

10. The Ventas lease contained financial covenants (the "financial covenants"), which required that ALC maintain certain quarterly and trailing twelve-month occupancy percentages and coverage ratios, both at each facility and at the portfolio level. The lease defined "coverage ratio" as cash flow divided by rent payments. The Ventas lease required ALC to demonstrate its compliance with the financial covenants on a quarterly basis by providing Ventas, within 45 days of the end of each quarter: (1) facility financial statements prepared in accordance with general accepted accounting principles ("GAAP"); (2) schedules documenting compliance with the financial covenants; and (3) an officer's certificate, signed by an ALC executive, attesting to the completeness and accuracy of such information.

11. The lease provided that if ALC violated any of the financial covenants, Ventas could: (1) terminate the lease in its entirety; (2) evict ALC from all eight facilities; and (3) require ALC to pay accelerated rent equal to the net present value of the unpaid rent for the remaining term of the lease. ALC disclosed the net present value of its unpaid rent, as of its 2009, 2010, and 2011 fiscal year-end, to have been approximately $24.9 million, $20.9 million and $16.7 million respectively. The lease also provided that it could only be modified by a writing signed by

authorized representatives of both ALC and Ventas and that all "notices, demands, requests, consents, approvals and other communications" under the lease were to be in writing with a copy to Ventas's general counsel. Other provisions of the lease required ALC to use the Ventas facilities solely for their primary intended use and in a manner consistent with their operation as healthcare facilities.

### 2. ALC's Fraudulent Scheme to Hide the Covenant Defaults

12. Beginning in 2008, shortly after ALC entered the Ventas lease, occupancy at the Ventas facilities declined sharply. As a result of the occupancy declines, from at least the first quarter of 2009 through the fourth quarter of 2011, ALC failed, by a significant margin, many of the occupancy and coverage ratio covenants contained in the Ventas lease. Nevertheless, in each Form 10-K and 10-Q ALC filed during that period, ALC falsely represented that it was in compliance with the Ventas lease financial covenants. ALC also disclosed that non-compliance with the financial covenants could result in a "material adverse impact" on ALC. Moreover, beginning with the second quarter of 2011, ALC falsely represented in its 2011 Forms 10-K and 10-Q that "it did not believe that there is a reasonably likely degree of risk of breach of the [Ventas] covenants." ALC included this additional disclosure in response to a comment letter received from the Commission's Division of Corporation Finance.

13. To hide ALC's failure to comply with the covenants from Ventas, ALC's CEO, Laurie Bebo, and CFO, John Buono, directed ALC accounting personnel to include in the covenant calculations between 49 and 103 fabricated occupants for every day from July 2009 through December 2011.[4] To establish the number of fabricated occupants to be included in the covenant calculations, ALC accounting personnel, at Bebo's and Buono's direction, reverse-engineered the requisite number of additional occupants needed to meet the covenants each quarter. ALC accounting personnel also prepared monthly journal entries to record revenue associated with the fabricated occupants which: (1) credited the fabricated occupant revenue to the individual Ventas facilities; and (2) debited revenue in the same amount in a corporate revenue account.[5] Shortly

[4] On December 3, 2014, the Commission instituted public administrative and cease and desist proceedings against Bebo and Buono, alleging violations of the antifraud, books and records, internal controls, reporting, and other provisions of the Exchange Act. *In the Matter of Laurie Bebo and John Buono, CPA*, Exchange Act. Release No. 73722. On January 29, 2015, the Commission entered an Order accepting Buono's offer of settlement, finding that he violated each securities law provision alleged against him, imposing a $100,000 civil penalty, and barring Buono from practicing before the Commission as an accountant or serving as an officer or director of a public company. Exchange Act Release No. 74177. On October 2, 2015, following a four-week evidentiary hearing, an Administrative Law Judge issued an Initial Decision making findings against Bebo. Initial Decision Release No. 893.

[5] As a result, ALC eliminated in consolidation the revenue associated with the fabricated occupants, and such revenue was not reported in its Commission filings. In addition, ALC did not include the fabricated occupants in the occupancy numbers reported in its Commission filings.

after the end of each quarter, ALC provided Ventas with covenant calculations which included the fabricated occupants in the occupancy covenant calculations and the revenue associated with the fabricated occupants in the coverage ratio calculations and thus falsely showed that ALC was meeting the covenants.

14. Bebo and Buono told Grant Thornton that Ventas had agreed that ALC could include in the covenant calculations ALC employees who travelled to and stayed at the Ventas facilities for business purposes.[6] However, in actuality, no such agreement existed and Ventas was never told that any ALC employees were being included in the covenant calculations. Even if Ventas had agreed that ALC could include in the covenant calculations employees who actually stayed at the Ventas facilities, given that only a small number of ALC employees actually did so, ALC would still have missed the covenants by significant margins.

15. In the third quarter of 2009, Grant Thornton asked ALC to identify the employees included in the covenant calculations. In response, Bebo created and provided Grant Thornton with a list identifying the employees and their associated lengths of stay at the Ventas facilities. Bebo would subsequently prepare and/or approve such a list for Grant Thornton for every quarter through the fourth quarter of 2011. However, given the small number of ALC employees that actually stayed at the Ventas facilities and the large number of fabricated occupants necessary to meet the covenants, Bebo chose to include on the list: (1) her family members and friends; (2) family members (including the seven-year old nephew) of another ALC executive; (3) employees who did not travel to, let alone stay at, the facilities; (4) employees of the Ventas facilities, who lived nearby and did not stay overnight at those facilities; (5) employees who had been terminated by ALC or employees who ALC anticipated hiring but who had not yet started; (6) various ALC employees as occupants of multiple Ventas facilities for the same time period; and (7) other individuals who were neither ALC employees nor residents of the Ventas facilities. ALC did not disclose any of this to Ventas.

16. The fraudulent scheme unraveled in the spring of 2012. In April 2012, Ventas, which was still unaware of ALC's use of employees in the covenant calculations, filed a lawsuit against ALC resulting from ALC's unrelated failure to meet state regulatory requirements. The following day, Bebo sent Ventas a settlement proposal pursuant to which Ventas would release ALC from liability for all claims including those arising from ALC including employees in the covenant calculations. The settlement proposal was the first time Ventas learned that ALC was including employees in the covenant calculations. On May 9, 2012, Ventas issued a notice of default in which it accused ALC of fraud based on the employee adjustment.

17. In the meantime, on May 2, 2012, one of ALC's accounting personnel filed a whistleblower complaint with the audit committee of ALC's Board of Directors. The complaint described the employee adjustment as a "sham" and disclosed that ALC had included in the covenant calculations: (1) employees who did not travel to the Ventas facilities; (2) certain

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[6] ALC's practice of including in the covenant calculations employees or other non-residents is sometimes referred to hereafter as "the employee adjustment."

employees at multiple facilities on the same day; and (3) Bebo's parents, husband, and a family friend. ALC immediately initiated an internal investigation, and Bebo was terminated shortly thereafter, purportedly for reasons unrelated to the employee adjustment.

18. In June 2012, ALC and Ventas settled their lawsuit. As part of the settlement, ALC purchased the Ventas facilities and certain other facilities from Ventas for an amount far greater than the appraised value of the facilities. ALC paid approximately $100 million to settle the litigation and purchase the facilities, even though independent appraisals only valued the purchased facilities at $62.8 million. Thus, in its second quarter 2012 interim financial statements, ALC included as an expense $37.2 million for "lease termination and settlement" and also wrote off the entirety of the remaining operating lease intangible assets associated with the Ventas facilities, which totaled approximately $8.96 million.

19. Grant Thornton issued audit reports containing unqualified opinions on ALC's 2009, 2010 and 2011 financial statements. Each of those financial statements falsely disclosed that ALC was in compliance with the financial covenants. Those audit reports and financial statements were included in ALC's Form 10-K Commission filings.

**3. In Connection with the 2009, 2010, and 2011 ALC Engagements, Koeppel and Robinson Were Aware of Numerous Risks and Red Flags Related to ALC's Covenant Calculation Practices**

20. ALC was one of the larger clients for Grant Thornton's Wisconsin practice.

**a. The 2009 Engagement**

21. By the beginning of Grant Thornton's 2009 engagement, Koeppel and other members of the engagement team were aware that occupancy at the Ventas facilities had declined and that ALC was close to defaulting on the financial covenants. For this reason, in connection with its planning meeting for the first quarter 2009 review, the ALC engagement team focused on the financial covenants. The planning meeting agenda, which Koeppel reviewed, indicated that the Ventas covenant calculations were an area to which the engagement team should "devote special attention" and that the engagement team should "look closely" at ALC's covenant calculations.

22. Three weeks later, in late April 2009, ALC accounting personnel sent a Grant Thornton junior engagement team member ALC's calculations of the occupancy and coverage ratio covenants for the quarter and underlying support for the numbers used in the covenant calculations. Shortly thereafter, the engagement team member noticed discrepancies for six of the eight Ventas facilities between the occupancy figures used in the covenant calculations and the underlying support. As a result, he sent an email to ALC accounting personnel asking for an explanation for the discrepancies.

23. In response, ALC accounting personnel emailed Grant Thornton a spreadsheet known as an "occupancy recon" which listed for each of the Ventas facilities for each month during the quarter: (1) the actual occupancy of the facilities; and (2) the number of ALC

"employees" which were added to the actual occupancy numbers for purposes of the covenant calculations. The occupancy recon revealed that ALC was adding a total of 24 "employees" into the occupancy calculations for every day in the quarter. A review of the information contained therein would have shown that ALC failed certain occupancy covenants without the inclusion of employees.

24. ALC accounting personnel also provided the junior engagement team member with purported "support" for the employee adjustment, which was a February 4, 2009 email from Bebo to a Ventas employee (the "February 4 email"). However, the February 4 email made no mention of the financial covenants, and merely mentioned that ALC may rent rooms at the Ventas facilities to certain of its employees "in the ordinary course of business." The junior engagement team member elevated the issue to Grant Thornton's engagement manager, yet Grant Thornton did not receive any additional support from ALC. The engagement team told Koeppel about the employee adjustment and described it as unusual, but told Koeppel that the team had reviewed documentation which the team believed evidenced an agreement with Ventas. However, Koeppel never reviewed that documentation nor attempted to learn other details about it.

25. Grant Thornton did not perform additional procedures, such as seeking confirmation from Ventas that it had agreed to the use of employees in the covenant calculations. In fact, Grant Thornton would never seek confirmation from Ventas that it had agreed to the use of employees in the covenant calculations. Had Grant Thornton done so, it would have confirmed that Ventas never agreed to the employee adjustment.

26. Grant Thornton's workpapers for the first quarter of 2009 do not contain the February 4 email or reference ALC's inclusion of employees in the covenant calculations. The workpapers do reflect that Grant Thornton determined that ALC passed the covenant calculations based on the adjusted numbers contained in the occupancy recons.

27. ALC's management representation letter to Grant Thornton for the first quarter of 2009 and every quarterly review and audit in fiscal year 2009, 2010 and 2011 contained a representation that ALC had complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

28. In the course of Grant Thornton's second quarter 2009 review, a Grant Thornton summer intern was tasked with performing the procedures with respect to ALC's compliance with the Ventas lease covenants under the supervision of an audit senior. The intern reviewed an occupancy recon showing that ALC was including approximately 23 employees in the covenant calculations for every day of the quarter. The intern then prepared a note to the workpapers referencing the employee adjustment, which included language from the February 4 email, and stated:

> The employee adjustment relates to extra rooms at each facility not currently occupied by ALC residents. The rooms are subleased through ALC to improve the overall performance of each facility...Since the units are subleased, an adjustment is needed to show ALC occupancy and for Ventas testing.

Koeppel signed off on this workpaper, even though she knew there were no formal sublease agreements for any employee-occupied rooms.

29. For the third quarter of 2009, Grant Thornton reviewed occupancy recons showing that ALC had included 45, 65 and 75 employees for each day of July, August and September respectively. At Koeppel's request, the occupancy recons now included a list showing the names of the ALC employees purportedly staying at each Ventas facility, and the attendant length of their purported stay. This information would be contained in each subsequent occupancy recon, which showed employees staying at the facilities for every day of each month they were listed as an occupant. Koeppel never instructed the engagement team to perform additional procedures related to the list of names to determine whether the list of employees, or the length of the employees' purported stays, was accurate or appropriate. Moreover, Koeppel never asked the engagement team what procedures, if any, the team was performing with respect to the list of names. Had Koeppel, or later Robinson, asked the engagement team to perform substantive procedures on the list of names, Grant Thornton would have discovered that the list was fraudulent.

30. As part of its third quarter review, Grant Thornton, requested that ALC include in its representation letter the representation that ALC had "calculated the [Ventas] lease covenants in accordance with the corresponding lease agreement and the lessor's instructions." The engagement team wanted this representation included in part because it was concerned about the employee adjustment. In response, ALC modified the requested representation, and included the following in its representation letter: "We have calculated the [Ventas] lease covenants in accordance with the corresponding lease agreement and *as understood by us after conferring with the lessor*." (Emphasis added). Grant Thornton's workpapers do not contain an explanation for the modification in the language.

31. Grant Thornton's workpapers for the third quarter 2009 review observed that one of the Ventas facilities had unexpected or unusual revenue trends in that changes in revenue could not be explained by corresponding changes in occupancy. The workpapers addressing these trends noted that a Grant Thornton junior engagement team member had spoken with ALC personnel who explained that: (a) ALC employees were staying at the Ventas facilities per an agreement with Ventas; and (b) that such employees "pay rent and increase revenue," but are not counted toward ALC's company-wide occupancy numbers. This notation in the workpapers, which Koeppel reviewed, conflicted with her understanding that ALC employees included in the covenant calculations did not pay rent.

32. In the course of Grant Thornton's 2009 year end audit, Koeppel reviewed risk assessment workpapers that she understood referred to risks associated with the Ventas financial covenants.

33. In connection with that audit, and in the subsequent 2010 and 2011 audits, Grant Thornton documented that ALC was using "unusual" journal entries in connection with the employee adjustment. Those journal entries recorded "negative revenue" in a corporate revenue account to offset $1.2 million in non-GAAP revenue on the financial statements of the Ventas facilities associated with the employees included in the covenant calculations. The result of the

offsetting revenue meant that the employee revenue reported to Ventas was eliminated from ALC's consolidated financial statements. Koeppel, and later Robinson, was aware of these unusual entries yet never instructed the engagement team to perform additional testing on the employee adjustment.

34. Also in connection with the 2009 year end audit, the Grant Thornton engagement team planned on conducting site visits to five Ventas facilities in Georgia and one in South Carolina to, among other things, verify facility occupancy figures, physically inspect the houses and the assets therein, make fraud inquiries with facility employees and review documentation that was maintained at the facilities. However, ALC requested that the engagement team choose other site visit locations in lieu of the Georgia facilities, and Koeppel acquiesced to ALC's request.

35. Koeppel also reviewed a workpaper detailing ALC's monthly revenues for each of its facilities. That workpaper also indicated the occupancy rates for each facility. The workpaper showed that the occupancy rate for seven of the eight Ventas facilities fell far short of the rates required by the lease covenants.

36. In the course of the 2009 year end audit, Grant Thornton reviewed occupancy recons showing that ALC was including 103 employees in the covenant calculations for each day of the fourth quarter, yet failed to mention the employee adjustment in the covenant calculation workpapers. Nevertheless, Koeppel signed off on those workpapers. In addition, Koeppel determined that a representation specific to the use of employees in the covenant calculations, such as the one included in the third quarter 2009 letter, was no longer necessary for ALC's representation letter. No such representation was included in the representation letters for any subsequent ALC audits and reviews in the relevant period.

**b. The 2010 Engagement**

37. In connection with its planning meeting for the first quarter 2010 review, Grant Thornton again focused on the financial covenants. The planning meeting agenda, which Koeppel reviewed, noted that the Ventas covenant calculations were an area to which the engagement team should "devote special attention" and that the engagement team should "make sure we are testing the [Ventas] lease covenant calculations."

38. For the first and second quarter 2010 reviews, Grant Thornton reviewed occupancy recons showing that ALC included 103 employees in the covenant calculations each day from January through May, and included 90 employees each day in June.

39. By the time Grant Thornton was conducting field work for the third quarter 2010 review, Grant Thornton national professional standards and risk management personnel had become aware of negative quality indicators with respect to Koeppel, who was placed on a November 2010 monitoring list for partners with such negative indicators. Grant Thornton placed Koeppel on this list because, among other things, her audit clients had restated their financial statements or interim financial information four times in the preceding two years. The Public Company Accounting Oversight Board ("PCAOB"), in its 2008 inspection report, had also found

deficiencies on one of Koeppel's engagements because Grant Thornton had failed to gather sufficient audit evidence.

40. One of the restatements that led to Koeppel's inclusion on the partner monitoring list involved Grant Thornton's audit client, Koss Corporation ("Koss"). In June 2010, Koss restated its financial statements for the preceding two fiscal years because one of its vice presidents had embezzled $31.5 million from 2005 through 2009 and would plead guilty to criminal charges based on the misconduct. Koeppel was the engagement partner for the Koss audit for three of the four years of the embezzlement. In July 2012, Grant Thornton, without admitting any liability, paid $8.5 million to settle a malpractice case filed by Koss.

41. By November of 2010, Grant Thornton's National Professional Practice Director for the Midwest region ("NPPD") became aware of negative audit quality indicators with respect to Koeppel as a result of an ongoing PCAOB inspection. Although the NPPD did not know that Koeppel had been placed on the partner monitoring list, he was informed by others in the firm that Koeppel had a number of negative audit quality indicators. The NPPD also became aware of observations by other Grant Thornton partners that the Wisconsin practice, for which Koeppel was the managing partner, had "gotten off the tracks from a methodology perspective."

42. By the fall of 2010, Grant Thornton had removed Koeppel from all of her other public company engagements,[7] but decided to allow her to continue as the engagement partner for the 2010 ALC audit.

43. Following the completion of the second quarter 2010 review, the audit manager assigned to the ALC engagement team resigned. During the planning stages for the third quarter review, Grant Thornton assigned a new engagement manager (the "Engagement Manager") to be co-engagement manager on the ALC engagement. During the third quarter 2010 review, Koeppel became aware that the other Grant Thornton auditor assigned to be the co-manager of the ALC engagement was removed from the engagement. Koeppel knew that this left the Engagement Manager as the only manager on the ALC engagement.

44. The Engagement Manager's assignment as the sole engagement manager for the ALC engagement contravened Grant Thornton policy, which required that lead managers and partners on public company audit engagements be "SEC designated" to ensure that those individuals had the appropriate level of experience and understanding about Commission requirements. To obtain such a designation, an auditor was required to spend 200 hours on public company engagements in a prescribed time period and complete certain continuing professional education courses.

45. Koeppel knew that the Engagement Manager was not SEC designated due to the Engagement Manager having spent insufficient time on public company engagements. Koeppel

[7] Grant Thornton removed Koeppel from the remainder of her audit and review engagements, including private company engagements, after completing her work on financial statements or interim financial information for years or quarters ending December 31, 2010.

also knew that the other Grant Thornton auditor assigned to be the co-manager of the ALC engagement, who was SEC designated, was removed from the engagement. Koeppel knew that this left the Engagement Manager, despite her lack of SEC designation, as the only manager on the ALC engagement.

46. On October 22, 2010, shortly after the Engagement Manager started working on the ALC engagement, one of her subordinates brought the issue of the inclusion of employees in the covenant calculations to the Engagement Manager's attention. The email the Engagement Manager received stated:

> You will also see that the only way some of the houses are passing [the occupancy] covenant is by having these [employee] adjustments. In prior quarters, as well as again this quarter, we have asked for support for these [employee] adjustments but they haven't [been] able to provide any. In prior quarters I have also asked if they have any support (letters, emails, etc. from [Ventas]) to show that [Ventas] is aware that ALC is adding in [employees] and is okay with it. They have nothing. [the Engagement Manager's predecessor manager] said that all we can do then is rep it... Since you are new to the job, I wanted to bring this to your attention and make sure you are comfortable with this as well. Is there anything else we should do with this?

47. A few days later, an engagement team member emailed the Engagement Manager a copy of the Ventas lease and noted that she could not locate any provisions that defined "occupancy." The Engagement Manager responded that she also could not find any such provisions and intended to contact ALC accounting personnel who prepared the covenant calculations for additional information. The Engagement Manager believed it was necessary to speak to ALC accounting personnel because ALC's inclusion of employees did not comport with the traditional definition of "occupancy" for assisted living facilities.

48. The Engagement Manager then spoke with the ALC accountant who prepared the occupancy recons. Based on this conversation, the Engagement Manager believed that ALC was possibly providing Ventas with the occupancy recons and that this allowed Ventas to discern that ALC was including employees in the covenant calculations. In an email documenting her conversation with the ALC accountant, the Engagement Manager wrote that the accountant "did say he gives [Ventas] the more detailed spreadsheet that we have, so he thinks if they had a problem with it, they would have said something." She added:

> If I can get John [Buono] to confirm this, then I think we can document that they receive [the occupancy recon], have opportunity to disagree, etc. I'd still like it in the rep letter too then. But at least I feel more comfortable that they see the detail.

49. The Engagement Manager then attempted to contact Buono, who was unavailable. The Engagement Manager left Buono a voicemail inquiring about ALC's use of employees in the

covenant calculations. In that voicemail, the Engagement Manager noted that based on her conversation with the ALC accountant, she believed that "maybe" Ventas received the occupancy recons showing ALC's inclusion of employees. The Engagement Manager did not ask anyone at Grant Thornton to review the materials ALC sent to Ventas, which would have shown that Ventas was not receiving information showing ALC's use of employees. Grant Thornton would not perform such a review until the year end 2011 audit.

50. After leaving Buono the voicemail, the Engagement Manager spoke with Koeppel. Koeppel indicated to the Engagement Manager that Koeppel was aware that ALC had been including employees in the covenant calculations for the previous six quarters and that Koeppel was comfortable with the practice. Following this conversation, the Engagement Manager emailed Buono and told him to ignore the voicemail.

51. The Engagement Manager also suggested to Koeppel that ALC include in its representation letter a representation relating to ALC's use of employees in the covenant calculations, but Koeppel determined that such a representation was unnecessary.

52. Thus, the Engagement Manager was dissuaded by Koeppel from following either of the Engagement Manager's recommendations – speaking with Buono and obtaining additional representations – for obtaining support for ALC's use of employees in the covenant calculations.

53. In the course of the third quarter 2010 review, Grant Thornton for the first time included copies of the occupancy recons (without the employee names) in its workpapers. Those materials, which Koeppel and the Engagement Manager reviewed, showed that ALC was including between 68 and 72 employees in the Ventas covenant calculations for each day of the quarter.

54. Grant Thornton also included two notes in the workpapers regarding ALC's use of employees in the covenant calculation. In the first note, Grant Thornton indicated that, as a result of the employee adjustment, the occupancy figures used in the covenant calculations differed from the figures provided in ALC's internal occupancy reports. In the second note, Grant Thornton explained that the difference was, in part, the result of the employee adjustment and wrote that: "The employee adjustment relates to extra rooms at each facility that are not currently occupied by ALC residents, but are set aside for ALC employees to improve the overall performance of each facility." The note also contained the incorrect observation that Ventas was receiving the occupancy recons showing the number of included employees, and had the opportunity to disagree with ALC's practices.

55. In addition, Grant Thornton included the Ventas lease covenants in its Summary of Significant Matters ("the SSM") for the third quarter 2010 review. Grant Thornton prepared the SSM to highlight to engagement partners and engagement quality reviewers, among others, important issues and questions encountered during the audit or review. In the SSM, Grant Thornton mistakenly noted that it had "confirmed" with Buono that Ventas received the occupancy recon. The SSM also noted that Grant Thornton was not able to "specifically test" ALC's use of employees in the covenant calculations, that Grant Thornton accordingly needed to rely on ALC's

representations about its covenant practices, and that such a representation was included in ALC's representation letter.

56. Both Koeppel and the Engagement Manager reviewed the SSM. The Engagement Manager knew or should have known that the SSM incorrectly noted that Buono had represented that Ventas received the occupancy recons.

57. In advance of Grant Thornton's third quarter 2010 meeting with ALC's audit committee, the Engagement Manager added the Ventas covenants as a written agenda item for Grant Thornton's presentation to the committee. However, Koeppel removed the agenda item from Grant Thornton's presentation.

58. In planning for the year end 2010 audit, Grant Thornton scheduled site visits to the Ventas facilities after Koeppel and the Engagement Manager determined that those facilities were at higher risk for inaccurate occupancy reporting because of the Ventas lease covenant requirements and because ALC was barely passing the covenants. However, Grant Thornton's workpapers documenting its site visits to the Ventas facility do not reference any steps to validate the inclusion of employees in the covenant calculations. In fact, the Grant Thornton engagement team member who performed the site visit testing was unaware of the employee adjustment. Had Grant Thornton asked, employees who worked at the Ventas facilities would likely have told the Grant Thornton engagement team that only a handful of employees were staying at the facilities at any given time and that no rooms were being set aside or reserved at their facilities for employee use. Despite identifying the Ventas facilities as posing a higher risk, Koeppel failed to sign off on the results of the site visit procedures performed. Koeppel also failed to direct the site visit team to obtain support for ALC's use of employees in the covenant calculations, and failed to follow-up with the team to see if any such support had been obtained.

59. In the course of the year end 2010 audit, the Engagement Manager received a spreadsheet which showed the number of employees ALC included in the covenant calculations for each month during 2009 and 2010. One hour after receiving this information, the Engagement Manager sent an email to her subordinate, in which the Engagement Manager wrote:

> 2009 is quite odd-how do they suddenly have 70 employees staying here one month? Did we discuss this with them last year (i.e. how were they tracking these before)? Also, they go from 70, then down to 24, then back up. This seems very odd. . . . Not sure how accurate this is.

Nevertheless, the Engagement Manager failed to make any inquiries to ALC regarding her concerns or document her concerns in the workpapers.

60. Grant Thornton's workpapers for the 2010 year end audit included the occupancy recons, which showed that ALC included 61 employees in the covenant calculations for each day of the fourth quarter. The workpapers also noted that ALC would fail the occupancy covenants without the inclusion of employees. Both Koeppel and the Engagement Manager reviewed these workpapers.

61. For the 2010 year end audit, a Grant Thornton engagement team member suggested to Koeppel and the Engagement Manager that ALC's representation letter should contain a specific representation relating to ALC's use of employees in the covenant calculations. Koeppel responded, consistent with her view the prior quarter, by determining that the suggested representation was not necessary.

**c. The 2011 Engagement**

62. Robinson replaced Koeppel as the ALC engagement partner beginning with the first quarter 2011 review. With the exception of the third quarter 2011 review, Grant Thornton continued to staff the Engagement Manager as the manager on the ALC engagement. Prior to the 2011 year end audit, Grant Thornton approved the Engagement Manager's application for SEC designation, even though the Engagement Manager had still not completed the amount of public company engagement hours required under firm policy. In approving the application, Grant Thornton demanded that the NPPD continue to perform a detailed review in connection with the year end audit.

63. When Robinson assumed responsibility for the ALC engagement, the engagement team advised Robinson that ALC was including employees in its covenant calculations. After this was brought to Robinson's attention, he discussed the issue with Buono during an introductory lunch. Buono told Robinson that there was "an exchange of letters" that allowed ALC to use employees to meet the covenants. However, Robinson never obtained any such documentation.

64. During the first quarter 2011 ALC review, the Engagement Manager, as she had done with Robinson, brought the Ventas covenants to the attention of Grant Thornton's engagement quality reviewer (the "EQR"), who had joined the ALC engagement as the engagement quality reviewer on the 2010 audit. In the course of doing so, she sent an email informing the EQR that ALC was very close to missing the covenants.

65. In the course of the first quarter 2011 review, Grant Thornton learned that ALC had provided information showing that it failed one of the Ventas lease occupancy covenants. In reality, ALC had mistakenly included an insufficient number of employees to meet the covenant at issue. After Grant Thornton raised the failed covenant with ALC, ALC provided Grant Thornton with revised covenant calculations in which ALC added employees in order to pass all of the covenants.

66. In the following days, a Grant Thornton engagement team member emailed the Engagement Manager to apprise the Engagement Manager of her concerns that ALC had added employees after initially failing a covenant. The engagement team member also proposed that the Engagement Manager request from Buono a letter confirming Ventas's agreement to allow employees to be included in the covenant calculations. When the engagement team member spoke with the Engagement Manager, the Engagement Manager shared her assessment that ALC's use of new employees to remedy a covenant failure was "odd." However, Grant Thornton did not request additional support from ALC. When a second junior engagement team member learned that Grant Thornton had not followed up with Buono on obtaining a letter concerning the employee

adjustment, he wrote an email to the first engagement team member observing that: "I don't think we're ever going to get this mystery letter."

67. ALC's workpapers for the first quarter 2011 review included the occupancy recons, which showed that ALC included between 60 and 65 employees in the covenant calculations for each day of the quarter. The workpapers also noted that ALC would fail the occupancy covenants without the inclusion of employees. Both Robinson and the Engagement Manager reviewed these workpapers. In a separate section of the workpaper, Grant Thornton noted that ALC had failed the occupancy covenant for one of the facilities in the first draft of the covenant calculations but explained that Buono had "found" additional employees which allowed ALC to pass.

68. The SSM for the first quarter 2011 review again identified the Ventas covenants as a significant matter. The relevant paragraph was substantially similar to the paragraph in the third quarter 2010 SSM except that it omitted the reference to Buono's representation that Ventas was receiving occupancy recons. Robinson, the EQR, and the Engagement Manager each reviewed this SSM.

69. At Robinson's request, Grant Thornton sent ALC a proposed representation letter for the first quarter 2011 review which contained a specific representation relating to the inclusion of employees in the covenant calculations. However, when Buono requested that Grant Thornton remove this representation, Robinson and the Engagement Manager acquiesced.

70. In the course of its second quarter 2011 review, Grant Thornton learned that ALC had received a comment letter from the Commission's Division of Corporation Finance relating to ALC's 2010 Form 10-K, which requested, among other things, that ALC disclose its performance relative to the Ventas covenants if it remained at "risk of non-compliance." Grant Thornton reviewed ALC's proposed response to the comment letter, in which ALC wrote that it did "not believe that it has a reasonably likely degree of risk of breach of the [Ventas] covenants" and that it would add such a disclosure to its subsequent Commission filings. ALC in fact added such a disclosure to its Commission filings beginning with its second quarter 2011 Form 10-Q. Grant Thornton did not suggest any revisions to ALC's final response letter or to ALC's additional disclosure in its Commission filings.

71. ALC's workpapers for the second and third quarter 2011 reviews included the occupancy recons, which showed that ALC included between 73 and 88 employees in the covenant calculations for each day of the quarter. The workpapers again noted that ALC would fail the occupancy covenants without the inclusion of employees.

72. The SSM for the second and third quarter 2011 reviews contained identical paragraphs as the first quarter 2011 SSM with respect to the Ventas covenants. Robinson, the Engagement Manager, and the EQR reviewed both SSMs.

73. In preparation for the 2011 year end audit, Grant Thornton again recognized the risk associated with the financial covenants. The planning meeting agenda for the audit included an item identifying areas where "ALC management could perpetrate and conceal fraudulent

financial reporting." The agenda identified "occupancy (affecting covenants and bonuses)" as one such area for potential fraud. Robinson, the EQR, and the Engagement Manager reviewed this agenda.

74. During the 2011 audit, Grant Thornton for the first time requested a copy of the quarterly covenant calculations that ALC sent to Ventas. Grant Thornton made this request after the Engagement Manager reviewed the fourth quarter 2011 occupancy recon and saw that 50 percent of the available units at one of the Ventas facilities and 25 percent of the available units at another facility were purportedly occupied by ALC employees.

75. In response to Grant Thornton's request, ALC provided copies of the quarterly materials it sent to Ventas. Those materials, like all of the earlier covenant information ALC had provided to Ventas, did not contain any information indicating that employees were being included in the covenant calculations or the number of such employees.

76. A Grant Thornton engagement team member emailed the materials to the Engagement Manager and wrote: "The excel document [sent to Ventas] is exactly what we receive [in the occupancy recons], except they exclude the tab where they add employees (*as we had kind of expected*)" (emphasis added). The Engagement Manager responded to the email by writing that "I just don't know how comfortable I am with this." the Engagement Manager wrote that she called Buono to seek an explanation, but left a voicemail when Buono did not answer. The engagement team member then forwarded the Engagement Manager's email to a junior team member, but not the Engagement Manager, writing: "I wish I could be on this call . . ." The junior engagement team member responded: "Holly s---."

77. Buono did not return the Engagement Manager's call. In the meantime, the engagement team continued to be concerned about the employee adjustment. The day after leaving the voicemail for Buono, the Engagement Manager emailed Robinson and noted that the Ventas covenant calculations were still an "open item" because: (1) ALC wasn't sending Ventas the employee occupancy information that Grant Thornton had been reviewing; and (2) she wanted to question Buono on why so many of the occupants at two Ventas facilities were ALC employees.

78. Eight days after the Engagement Manager left the voicemail, Buono still had not returned her call. The Engagement Manager then left another voicemail for Buono in which she said that she wanted to discuss the Ventas covenants because the numbers for the quarter looked "odd." Four days later, when Buono still had not returned her calls, the Engagement Manager emailed Robinson to ask whether they should speak with the Chairman of ALC's Audit Committee because Buono "still hasn't responded to my questions with my concerns about how they are 'meeting' these covenants."

79. In the meantime, both Robinson and the Engagement Manager again suggested adding a representation to ALC's representation letter that specifically addressed the Ventas covenants, and Grant Thornton included such a representation in the draft letter it sent to ALC.

80. Eleven days after the Engagement Manager's initial voicemail to Buono, the two finally spoke. On the call, the Engagement Manager failed to raise her concerns that ALC employees represented 50% of the occupancy of one Ventas facility and 25% of the occupancy of another facility. Rather, Buono requested that Grant Thornton remove the Ventas covenant representation contained in the draft representation letter Grant Thornton had sent to ALC.

81. In response, the Engagement Manager asked Buono to provide some evidence that Ventas knew that ALC was including employees in the covenant calculations. Buono then described to the Engagement Manager: (1) a conference call with Ventas in 2009 during which Buono claimed that Ventas was notified about the inclusion of employees in the covenant calculations; and (2) an email from Bebo to Ventas confirming such conversation. The conversation ended with the Engagement Manager requesting a copy of the email.

82. Shortly after the conversation, Buono sent the Engagement Manager via email a copy of the February 4 email, which contained no mention of the Ventas covenants. The Engagement Manager also provided a copy of the February 4 email to Robinson. One minute after receiving the February 4 email from Buono, the Engagement Manager responded to Buono that she would remove the Ventas covenant specific representation from the final representation letter. The Engagement Manager did not consult with Robinson before removing the representation. However, in a subsequent conversation with Robinson, the Engagement Manager described the sequence of events and Robinson indicated his agreement with her decisions.

83. Grant Thornton's 2011 audit workpapers included the occupancy recons, which showed that ALC included 92 employees in the covenant calculations for each day of the fourth quarter. The workpapers also contained a notation that the revenue associated with the employee occupants allowed ALC to satisfy the coverage ratio covenants. Other workpapers, which Robinson and the Engagement Manager reviewed, also contained the incorrect observation contained in prior workpapers that Ventas received quarterly information showing the number of employees ALC included in the covenant calculations.

84. As was the case for 2009 and 2010, Grant Thornton issued an audit report that included an unqualified opinion on ALC's 2011 financial statements.

**4. The 2012 Engagement**

85. During the reviews of ALC's interim financial statements for the first and second quarters of 2012, Robinson, the EQR, the Engagement Manager and the NPPD received additional information which indicated the impropriety of ALC's inclusion of employees in the covenant calculations. Grant Thornton did not withdraw its audit opinions on ALC's prior period financial statements.

86. In the course of its first quarter 2012 review, Grant Thornton learned that Ventas had issued notices of default to ALC as a result of ALC receiving license revocations at certain of the Ventas facilities. On April 24, 2012, the Engagement Manager emailed Robinson to express

her concerns regarding ALC's efforts to resolve its disputes with Ventas, which included ALC offering Ventas $15 million to terminate the lease. The Engagement Manager wrote:

> Ventas may not realize the full extent to which occupancy has dropped. Although they are getting close to a deal on the properties now, what happens when Ventas finds out occupancy is actually much lower than expected as ALC has been filling with employees. This is going to happen when they enter the properties. I wonder if Ventas might ask for more then because they may see it as the properties having depreciated more.

87. On April 26, 2012, when the efforts to settle the license revocation issues collapsed, Ventas sued ALC in federal court. ALC and Ventas would ultimately settle that litigation, after Ventas learned that ALC was including employees in the covenant calculations, with ALC purchasing the Ventas facilities for $37 million more than the facilities' appraised value.

88. In May 2012, Robinson, the EQR, the Engagement Manager and the NPPD learned that a whistleblower had submitted a complaint to ALC's Audit Committee relating to the inclusion of employees in the covenant calculations and that ALC's Audit Committee had retained a prominent law firm to conduct an internal investigation of the allegations. While Grant Thornton was not provided with a copy of the whistleblower complaint until December 2012, ALC's law firm described the whistleblower's allegations to Robinson and the Engagement Manager during a meeting on May 14, 2012. In its workpapers, Grant Thornton noted that the whistleblower had alleged that the employees included in the covenant calculations were not performing any services at the Ventas facilities or even leaving ALC headquarters. The workpapers also noted the whistleblower's disclosure that the employee numbers were reverse engineered to meet the covenants. Robinson, the EQR, and the Engagement Manager prepared or reviewed these workpapers.

89. On May 11, 2012, Robinson received an email from the Chairman of ALC's Audit Committee attaching notices of default which ALC had received from Ventas. In one of those notices, Ventas asserted that ALC had committed fraud by including employees in the covenant calculations. In the cover email, ALC's Audit Committee chair indicated that ALC management was not authorized to speak with Grant Thornton about the matters being investigated by the law firm retained by ALC's Audit Committee.

90. In the course of Grant Thornton's second quarter 2012 review, the Engagement Manager prepared workpapers to explain the accounting for ALC's purchase of the Ventas facilities, which indicated that ALC had paid Ventas $37 million in excess of the appraised value of those facilities "for damages as a result of occupancy rates falling significantly below required covenant occupancy rates." Robinson, the EQR, the NPPD and other members of Grant Thornton's professional standards group reviewed these workpapers.

## F. KOEPPEL'S AUDIT AND REVIEW OF BROADWIND

### 1. Background on the Recording of Intangible Assets

91. GAAP typically does not permit the recognition of intangible assets, such as customer relationships, as independent assets on a company's balance sheet. An exception to this general rule is intangible assets purchased in connection with a business combination. In that context, GAAP requires the consideration for an acquisition to be allocated across the tangible and intangible assets, with the remainder recorded as goodwill.

92. In connection with the Brad Foote acquisition in October 2007, Broadwind recorded amortizable intangible assets of $76 million and goodwill of $26 million. Nearly the entire $76 million intangible asset related to Brad Foote's contracts with its two most significant customers, Customer 1 and Customer 2, which were recorded at $62 million and $13 million, respectively. To establish the intangible asset value, management relied on a valuation conducted by an appraisal firm, Appraisal Firm 1. Appraisal Firm 1's valuation depended in substantial part on the forecasted net cash flows derived from the Customer 1 and 2 contracts over ten- and nine-year periods, respectively. Appraisal Firm 1 calculated those net cash flows from forecasts and estimated growth rates provided by senior managers at Broadwind. The net sales forecasts reflected management's anticipation of aggressive growth.

93. Once established, an amortizable intangible asset is subject to periodic impairment testing. According to Accounting Standards Codification ("ASC") 360, originally promulgated as Financial Accounting Standard ("FAS") 144, an intangible asset is impaired when the carrying amount of the asset exceeds its fair value. A company is required to make this determination "whenever events or changes in circumstance indicate that its carrying amount may not be recoverable." One such "triggering event" is "a current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (or asset group)." Other examples of such triggering events include "a significant adverse change in the extent or manner in which a long-lived asset (or asset group) is being used or in its physical condition" or "a significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (or asset group), including an adverse action or assessment by a regulator." Broadwind purported to follow the accounting principles established by FAS 144.

### 2. The Decline of Broadwind's Customer Relationships

94. Beginning in late 2008, Customers 1 and 2 significantly reduced actual and forecasted orders, causing substantial declines in Brad Foote's projected revenue associated with those relationships. Broadwind reacted to the downturn by planning or implementing numerous initiatives to rationalize the business, including decreasing headcount, returning machines to equipment suppliers, altering production schedules, and withholding investments in additional capacity.

95. Throughout the first quarter of 2009, the declines in Customer 1 and 2's revenues and forecasts worsened, falling more than 66% and 71% from the original forecast used to value the customer relationships. In response, Brad Foote took steps to restructure its workforce and operations, laying off more than 200 employees and senior staff through at least three workforce reductions, and reducing its material orders from suppliers. Brad Foote aggressively sought business from other non-wind customers to replace the significant declines and correct the underutilization of its capacity.

96. In early 2009, as its financial condition worsened, Broadwind received early indications of potential impairment while preparing its 2008 annual report. During its 2008 financial statement audit, Broadwind retained Appraisal Firm 1 to test its goodwill and intangible assets for potential impairment. In March 2009, Appraisal Firm 1 informed Broadwind that it had calculated a $15 million impairment charge associated with the Customer 1 contract. Appraisal Firm 1 subsequently modified its calculations, which resulted in no impairment. Although the Company ultimately did not disclose a charge in its 2008 Form 10-K, following consultation with Grant Thornton, Appraisal Firm 1's preliminary result placed Broadwind's management on further notice of the potential for impairment.

97. During the second quarter of 2009, the Customer 1 and 2 relationships deteriorated more precipitously. At a special board meeting convened on June 9, 2009, Brad Foote management reported that Brad Foote would produce no more than $85 million in sales for 2009, compared to $120 million in previously anticipated sales. Management also reported that 2009 revenue forecasts for Customer 1 had decreased to $30 million and that the 2009 revenue forecasts for Customer 2 had declined to $15 million. In connection with a "massive and sudden schedule" reduction imposed by Customer 1 and other developments, Broadwind and Brad Foote began developing a "life without Customer 1" business plan, and several members of management expressed the desire to exit the relationship.

98. For Brad Foote as a whole, second quarter 2009 revenue fell 31% against the second quarter of 2008 and 24% compared to the first quarter of 2009, and its gross margin turned negative. As in previous months, Brad Foote continued its efforts to redirect sales from Customers 1 and 2 to new customers and implemented additional workforce reductions..

99. In the third quarter of 2009, Brad Foote's actual and forecasted revenue continued to decline. Specifically, year-to-date revenues from Customer 1 and Customer 2 through September 30, 2009 declined 42% and 25%, respectively, compared to the same period ending September 30, 2008.

100. On July 29, 2009, Broadwind's CEO provided the Board a "rationalization update" that described the precipitous decline and the restructuring that management was taking to respond to weak performance. During the meeting, Brad Foote management presented a financial forecast for Brad Foote showing that the expectation for Brad Foote sales for 2009 had declined by $49 million, or 41% to a newly revised forecast of $71 million. Brad Foote management also projected net income of *negative* $16 million for the year. During a portion of the presentation

discussing "risks to [the] income statement," Broadwind management identified "continued loss of volume" and "impairment at subsidiaries."

101. The declines in actual and forecasted results were not limited to 2009. Revenue forecasts for future years also declined. For instance, on July 30, 2009, Customer 1 submitted a 2010 forecast that was only 13% of the $125 million 2010 projection used to establish the acquisition value of the Customer 1 contract.

102. Around this same time, Brad Foote management informed the Board that Brad Foote would generate revenues of $30 million from Customer 2 in 2010, $41 million in 2011, and $54 million in 2012. On average, those forecasts represented a 70% decline from the comparable period forecasts originally used to value the Customer 2 contract.

103. A board meeting was scheduled for October 1, 2009 to determine whether the Board should sever its relationship with Customer 1. At that meeting, the Board decided not to terminate Broadwind's relationship with Customer 1. However, Broadwind continued to budget for and anticipate impairment in several documents and communications through December 2009.

### 3. Broadwind's Misrepresentations and Omissions in Its Commission Filings

104. As a result of these developments, by the third quarter of 2009, the intangible assets associated with the Customer 1 and 2 relationships met the triggering event tests established by FAS 144, and these assets were impaired. Consequently, Broadwind materially overstated its intangible assets and understated a material impairment charge in its Form 10-Q for the third quarter of 2009, which was filed on November 2, 2009.

105. Given the declines in its business and other developments, Broadwind resolved in October 2009 to raise additional capital through a public offering of its stock. In anticipation of the offering that ultimately proceeded in January 2010, Broadwind filed a registration statement with the Commission. The registration statement was initially filed on October 30, 2009 and was amended various times between November 6, 2009 and January 14, 2010. The registration statement ultimately went effective on January 14, 2010. All versions of Broadwind's registration statement included the interim financial statements that had been included in the Forms 10-Q filed through the end of the third quarter, September 30, 2009, and expressly incorporated prior reports by reference.

106. As was the case with the third-quarter Form 10-Q, Broadwind's registration statement was incomplete and misleading. By incorporating third-quarter interim financial statements that did not report the impairment charge, Broadwind failed to disclose that its intangible assets already had been substantially impaired. Failing to disclose the impairment allowed Broadwind to proceed with an offering that was critical to its financial survival and to give the misleading impression that its business was stronger than actual and predicted results established.

107. Less than two weeks after the completion of the offering, on February 2, 2010, Appraisal Firm 2 informed Broadwind's management of its preliminary finding of impairment.

108. Approximately one month later, Broadwind disclosed the impairment in its 2009 Form 10-K and earnings release, filed on March 12, 2010. Broadwind disclosed a $58 million charge to intangible assets and full impairment of its goodwill related to Brad Foote in the amount of $24 million. Described by the Board as "significant," the charge reduced the value assigned to customer contracts by 94%. Of the $58 million intangible impairment charge, $56 million directly related to the declining value of the Customer 1 and 2 relationships. Largely as a result of the charge, Broadwind's operating loss for the year increased from $28 million to $110 million on reported revenues of $198 million.

109. Following the revelation of the charge, Broadwind's stock declined 21%, from a closing price of $5.68 on March 11, 2010 to a closing price of $4.47 on March 12, 2010, on increased volume. On the next trading day, March 15, 2010, the price fell another 8% from the March 11, 2010 price to $4.11, for a total decline of 29%. In contrast, the broader market, as reflected by the Nasdaq Composite Index, was essentially unchanged for these two days. The charge also was significant because it signaled serious weaknesses in Broadwind's long-term prospects, particularly with two of the industry's largest players.

110. Because Broadwind did not recognize impairment as a third-quarter event, its Form 10-K for 2009 misstated third and fourth-quarter results. In the Form 10-K, Broadwind inaccurately attributed the impairment charge to fourth-quarter events when the events that resulted in the impairment were present during the third quarter.

**4. Koeppel's Early Warnings of Potential Impairment**

111. In inspection reports issued beginning in 2007, PCAOB notified Grant Thornton of several impairment audit deficiencies in other engagements. Further, in its 2008 and 2009 inspection reports, PCAOB notified Grant Thornton of issues regarding the effectiveness of Grant Thornton's firmwide quality controls with respect to (1) professional skepticism, (2) engagement supervision, and (3) impairment procedures.

112. As Broadwind's auditor, Grant Thornton learned of the decline in sales and volume that began in late 2008, as well as the restructuring steps undertaken by Broadwind to address the declines, through its audit work. For instance, Grant Thornton reviewed Broadwind's board and committee materials in connection with each of its reviews and audits. Grant Thornton's work papers also noted various negative developments through its review of financial metrics and conversation with accounting personnel and others at Broadwind.

113. In addition, because it reviewed and analyzed Appraisal Firm 1's work during the 2008 annual audit in early 2009, Grant Thornton also received the early indications of potential impairment identified by Appraisal Firm 1. Although Broadwind ultimately did not disclose an impairment charge in its 2008 Form 10-K, the preliminary result placed Broadwind and Grant Thornton on notice of the potential for impairment.

114. During the quarterly review for the period ending March 31, 2009, Grant Thornton asked management to prepare a memorandum documenting its consideration of triggering events

that could indicate impairment of the intangible assets associated with the Customer 1 and 2 relationships. Management's memorandum to Grant Thornton recited the standard for impairment, noted the recent downturns, but summarily concluded that no triggering events had occurred.

115. Grant Thornton also requested a similar assessment for the second quarter of 2009. Management's memorandum again noted key customers' intentions to scale back orders, but summarily concluded these declines simply represented a delay in the timing of revenues and associated cash flows. With respect to the second quarter 2009 assessment, the senior manager for the Grant Thornton engagement team wrote the following to Koeppel:

> The problem is that the ability to forecast has been suspect with this group and whether or not the sales are suspended or eliminated is the question . . . their position is suspended which is how they get to no impairment. I think this meets adequate documentation at an interim date and not sure we are going to get a better product. Please let me know if you disagree and whether or not we should have more expansive forecasting to illustrate the expected revenues from these customers that have pushed out.

116. Despite these concerns, Koeppel failed to direct the engagement team to obtain more expansive forecasting from Broadwind, or to perform any additional procedures, during the second-quarter review. The Grant Thornton review file similarly included no documentation of any additional forecasting by Broadwind or additional procedures performed.

### 5. Koeppel Learns of Broadwind's Expectation of Impairment

117. In August 2009, after the continued deterioration of the Customer 1 and 2 customer relationships, Broadwind management shared with Grant Thornton its expectation that its intangible assets would be substantially impaired. Specifically, Grant Thornton received internal budgeted balance sheets and income statements for 2010 and other documents reflecting management's assumption that the entire Customer 1 contract intangible asset would be impaired by December 31, 2009. Several of these documents specifically identified an expected impairment charge of $48 million to be recorded in the fourth quarter.

118. After being informed on September 9, 2009 of management's expectation, Koeppel wrote to the senior manager: "Guess they see the writing on the wall for [Brad Foote]—seems like we need a triggering event?!?!?" One day later, the senior manager summarized for Koeppel a discussion with Broadwind's Chief Accounting Officer ("CAO") and Controller:

> The impairment has not been booked or determined, but they believe a Customer 1 triggering event is a week or two away and is based on a customer retention decision at the board level . . . [the CAO] feels they are slanting the board materials to keep Customer 1, but are not incorporating the true costs of the customer relationship which would potentially paint a different light.

119. Grant Thornton incorporated management's expectation in its planning for the third-quarter review and year-end audit of Broadwind's 2009 financial statements. On September 29, 2009, Broadwind and Grant Thornton met to plan the upcoming annual audit. Agenda and notes drafted by Grant Thornton in preparation for the meeting reflect "expected impairment," "loss of Customer 1 . . . FAS 144 writeoff," and the need "to get started as soon as possible." Relatedly, a client meeting agenda listed "impairment analysis" as a topic of discussion. Attachments to the agenda included other references to impairment and an estimated $48 million charge. A few days after the audit planning meeting, on October 4, 2009, Grant Thornton forwarded Broadwind's Controller guidance on impairment disclosures "as a follow up to [their] discussion regarding potential impairment."

### 6. Koeppel's Failed Review of Broadwind's Third-Quarter Impairment Assessment

120. Broadwind's third quarter ended on September 30, 2009. As discussed above, in early October 2009, Broadwind decided to raise additional capital through a follow-on offering of its stock, referred to as a "re-IPO," and began to prepare a registration statement. The Grant Thornton engagement team was aware that Broadwind was embarking upon an offering and understood that the offering was critical to Broadwind's financial survival. Grant Thornton also understood that Broadwind's CEO planned to participate in the offering by selling shares that he personally owned. Broadwind originally planned to complete the offering in late November 2009.

121. Grant Thornton's quarterly review of Broadwind's third-quarter interim financial statements began on October 21, 2009. On or about October 27, 2009, immediately before a planned filing of a registration statement, Grant Thornton learned that Broadwind's management had decided not to file the registration statement due to the withdrawal of the lead underwriter. After being informed by Broadwind's CFO that there were "underwriting issues at the last minute," Koeppel conveyed her understanding to the senior manager and manager that "impairment may be an issue/concern—they want to highlight it may occur—[the CAO's] and my concern is it starts to look like you should have already recorded it then—details, details!"

122. In connection with the third-quarter review, on or about October 29, 2009, despite prior communications of an expected impairment, Broadwind management once again prepared an impairment assessment for Grant Thornton that concluded that no triggering event had occurred. In the assessment, Broadwind incorporated a comparative table of year-to-date revenues by customer that reflected substantial revenue declines. Management summarily characterized these declines as temporary and asserted that long-term volumes had not been materially changed. However, management offered no specific evidence to support its view that orders would return to the volumes forecasted in 2007, and other facts contradicted its assertion. Based on this unsupported and incorrect conclusion, Broadwind failed to disclose a significant impairment charge in its Form 10-Q filed on November 2, 2009, opting instead for a generalized risk disclosure of the possibility of such a charge. Management's assessment was incorporated into a Grant Thornton working paper that was reviewed and approved by Koeppel and others on the engagement team.

123. Notwithstanding the awareness of a significant likelihood that the Customer 1 and 2 contracts were impaired, and despite lingering uncertainty about management's forecasting ability, Koeppel and others on the engagement team accepted management's unsupported assertion that the reduced orders only represented a temporary deferral of sales that would be recovered over the life of the supply agreement. Grant Thornton noted in its workpapers, which Koeppel reviewed:

> GT notes that although volumes are below those projected by mgmt during the 2008 integrated audit, management does not believe that this is a triggering event due to the following. (i) BFGW continues to have long-term contracts with [Customer 1 and 2]. For example, the Customer 1 contract contains automatic renewals, termination provisions, etc. Current discussions with Customer 1 indicate increased future activity. (ii) These are long-term relationships with an estimated useful life of 9 [Customer 2] and 10 [Customer 1] years. Thus, it is reasonable to assume that short-term reductions in volume will be made up over the longer term. Management does not believe, and GT concurs, that a short-term decrease from budgeted activity qualifies as a triggering event and such analysis does not seem to be supported by FAS 144.

124. Even though multiple facts known to Koeppel and the engagement team did not align with management's conclusion, and Grant Thornton knew that Broadwind was pursuing an offering, Grant Thornton did not perform any procedures to determine whether the order reductions were other than temporary. On the contrary, the review documentation noted that Grant Thornton simply "assume[d]" that these reductions were temporary. Among other things, Grant Thornton did not ask Broadwind to provide detailed information about Customer 1 and 2 volume expectations beyond 2009, which was available to management at the time. Grant Thornton's files do not include any documentation indicating how Koeppel or the engagement team determined the reasonableness and consistency of Broadwind's response in light of the results of other review procedures and their knowledge of the business.

125. In fact, Broadwind's response conflicted with longer-term forecasts presented to the Board as early as July 2009, which were available to Grant Thornton. Koeppel's experience with Broadwind since 2007 provided her with an understanding of Brad Foote's operations to recognize that Brad Foote required longer-term forecasts from Customer 1 and 2 to manage its material requirements and production schedule. Consequently, she should have known that 2010 volume forecasts were available at the time of the third-quarter triggering event assessment.

126. Further, during Grant Thornton's review of Broadwind's third-quarter impairment assessment memorandum, Grant Thornton's professional standards partner (the "PSP") assigned to the Broadwind engagement provided comments to Koeppel and the manager. The PSP had been assigned by Grant Thornton to monitor the Broadwind engagement as a result of Grant Thornton's designation of the engagement as high risk. In a communication to the engagement team about Broadwind's impairment assessment, the PSP wrote the following: "Are the revenues consistent with the projections used for their last impairment analysis? If they are significantly declined than that, then you would have a trigger you may need to revisit. They don't address this here. Also

need GT conclusion & view on impairment in the files." Although the team's own third-quarter revenue analytics working papers demonstrated that the revenues were not consistent with the projections used for Broadwind's last impairment analysis, the engagement team did not revisit the triggers for an impairment analysis. The manager responded to the PSP simply that management viewed the contracts as long term, such that a short-term decrease from budget would not qualify as a triggering event.

### 7. Koeppel Defers to Broadwind in Grant Thornton's Comfort Letter

127. Broadwind's third-quarter 2009 interim financial statements were incorporated into its registration statement for the public offering in January 2010. In connection with the offering, Grant Thornton was retained to provide a comfort letter to investment bankers and reviewed draft registration statements and impairment disclosures. As Grant Thornton performed its procedures, Koeppel and the engagement team learned that the Commission's Division of Corporation Finance had questioned Broadwind's impairment disclosures. As part of its review of Broadwind's registration statement, the Division of Corporation Finance issued Broadwind a comment letter in late November 2009. In response to comments questioning the Company's impairment disclosures, Broadwind added more detail to its description of its significant accounting policies in its MD&A and the notes to consolidated interim financial statements. However, the additional language simply provided more detail about the testing *process* and did not alter the substance of Broadwind's disclosures regarding impairment or the risk of impairment.

128. Following this expanded process disclosure, Koeppel and the senior manager defended the quality of Broadwind's disclosures surrounding impairment in email exchanges with the PSP. The PSP voiced serious reservations to the engagement team about the impairment disclosures and emphasized the company's obligation to provide an early warning to investors if it believed an impairment charge was reasonably possible. The PSP specifically cautioned Koeppel that "[w]e can't just turn a blind eye if we believe there is a good possibility they will have impairment." Koeppel and the senior manager addressed the PSP's concerns by obtaining a representation from management that impairment testing was in process but had not yet been completed. Grant Thornton's comfort letter expressly cautioned that it had not performed any procedures surrounding impairment of intangible assets with respect to the period from October to November 2009, deferring instead to its "inquiry of management."

### 8. Koeppel Negligently Audits Management's Allocation of Impairment Charge to the Fourth Quarter

129. In the course of its year end audit of Broadwind, Grant Thornton's workpapers failed to differentiate the fourth-quarter declines from comparable declines that occurred in prior periods. At the urging of the PSP just days prior to audit signoff, the engagement team considered whether the impairment charge should be recorded in the fourth quarter of 2009 or some earlier period. The resulting audit file memorandum, which Koeppel reviewed, relied on selected sales metrics to demonstrate a purported deterioration in the fourth quarter of 2009. In the memorandum, Grant Thornton reasoned that: (1) the fourth quarter 2009 revenue decline from fourth quarter 2008 (65%) and from third quarter 2009 (32%) was significant; and (2) prior to the

fourth quarter, actual and forecasted revenue amounts related to the reporting unit were consistent with previous expectations.

130. Grant Thornton's observation that, prior to the fourth quarter, actual revenues were consistent with the prior year's forecasted revenues was incorrect and was contradicted by the engagement team's own revenue analytics documentation in each of the first three quarters of 2009. The team's third-quarter review impairment workpapers also acknowledged this underperformance by stating "that, although volumes are below those projected by [management] during the 2008 integrated audit, management does not believe that this is a triggering event." In fact, Brad Foote's actual quarterly revenues in 2009 failed to meet the forecasted revenues used in the fiscal year 2008 impairment analysis by significant margins. Moreover, Grant Thornton's reasoning applied with equal force to *prior* quarters in 2009, and these declines were documented by Grant Thornton each quarter in its revenue analytics working papers. In the second and third quarters, Brad Foote realized comparable declines in revenue. Second quarter 2009 revenue fell 31% against second quarter 2008 and 24% compared to first quarter 2009. Third quarter 2009 revenue fell 49% compared to third quarter 2008 and 19% compared to second quarter 2009.

131. The engagement team's memorandum on this issue failed to discuss whether or how it considered the significant sales declines that had occurred in the third quarter in concluding the company was correct in recording the impairment charge as a fourth-quarter event. Further, the team's inclusion of the inaccurate statement that actual revenues were consistent with prior-year projections reinforced the company's incorrect allocation of the impairment charge to the fourth quarter. Koeppel and Grant Thornton sought only evidence to corroborate management's conclusion while disregarding evidence from their own prior work that contradicted management's conclusion.

132. Around the same time that the PSP had asked the engagement team to evaluate the timing of the impairment charge, Koeppel provided Broadwind's CFO with comments on Broadwind's draft earnings release to be issued in connection with the filing of Broadwind's 2009 Form 10-K. The CFO's draft had attributed the impairment charge to "reduced wind gearing purchases under key customer contracts *beginning in late 2008*." (emphasis added). Koeppel urged the CFO to reevaluate the language in the release. Koeppel wrote: "We view the following reference to 2008 as problematic as it may suggest that you should have taken the impairment charge earlier . . . Suggest that you expand the sentence to focus on Q4 events which drove this assessment." Koeppel proposed these revisions to the press release *prior* to the engagement team's drafting of the memorandum purporting to document its consideration of the charge's timing.

### 9. Koeppel's Failure to Detect Broadwind's Overstatement of Revenue

#### a. Koeppel Identifies Revenue Recognition Risks

133. In the course of the 2009 year end audit, Koeppel and Grant Thornton identified the risk of material misstatement due to fraud in the area of revenue recognition at Broadwind's most significant subsidiary, Brad Foote, as a specific risk. Audit planning documentation identified the risk that "sales include fraudulent transactions" as "high" and "reasonably possible." Planning

documentation further noted "possible incentive to play with earnings especially at the BFGW level (there are monthly sales targets included in their loan covenants)." More generally, Grant Thornton had identified the Broadwind engagement as a high-risk audit. This conclusion was influenced in part by Broadwind's prior disclosures of material weaknesses in controls over revenue recognition and other controls in earlier periods.

**b. Overstatement of Revenue by Broadwind**

134. This risk in fact materialized. The deterioration in customer relationships that produced the impairment charge also compromised Brad Foote's ability to meet monthly debt covenants associated with its primary credit facility. To avoid default and other negative consequences, Brad Foote personnel accelerated revenue to meet its covenants until Broadwind could raise funds to retire the credit facility through the offering in January 2010. Broadwind failed to disclose this practice and its effect on future revenue in the registration statement used in the offering. In addition, as a result of the transactions, Broadwind reported $4 million of improperly recognized revenue for the third and fourth quarters of 2009, including certain bill-and-hold transactions entered with Customer 2. This revenue was material to Broadwind's financial results.

135. The Customer 2 bill-and-hold transactions had their genesis in a broader "pull-ahead agreement" between Customer 2 and Brad Foote. In response to forecast reductions in early 2009, Brad Foote personnel approached Customer 2 about pulling $6 million of orders, consisting of 150 sets of gear boxes, from 2010 into 2009 "to ensure [Brad Foote's] future compliance with debt covenants" and its ability to continue supplying gearboxes to Customer 2. Brad Foote's proposal was not requested by Customer 2 or tied to any commercial need on the part of Customer 2 beyond the survival of a critical supplier. The 150 sets were to be pulled from requirements that were scheduled to ship in 2010 and would not be consumed until the first half of 2010. Because Customer 2 had no need for the sets and would carry the 150 sets as excess inventory, Brad Foote proposed "to cover Customer 2's carrying and storage costs through deflation in 2010." In addition, because the long-term agreement with Customer 2 provided for an annual reduction in prices paid by Customer 2, Brad Foote agreed to accept 2010 prices for the parts. Brad Foote committed that it would not ship the products to Customer 2 if it were able to identify new business from other customers. After initially refusing the request, Customer 2 agreed to provide $3 million of support. Customer 2 scheduled the 75 sets to be delivered from late August 2009 through November 2009. Brad Foote's delivery of these sets caused significant disruption at Customer 2, given its lack of need for the parts until 2010. Brad Foote paid Customer 2 the carrying cost and the price reduction through a 1.5% discount that was spread over shipments that occurred in 2010.

136. As a result of the pull-ahead agreement, by October 2009, Customer 2 exceeded its ability to store the excess inventory. Consequently, Customer 2 approached Brad Foote about storing the remaining gear sets through a bill-and-hold arrangement. On October 31, 2009, Brad Foote agreed and entered into a bill-and-hold arrangement with respect to 30 gear sets totaling $1,247,160. The gears were not shipped to Customer 2, but instead were supposed to be segregated and maintained onsite at Brad Foote. Customer 2 required Brad Foote to segregate the product and provide evidence of completion and periodically inspect the product on site.

Notwithstanding these efforts, Brad Foote failed to segregate the product consistently. The transaction failed to meet the criteria to recognize revenue under a bill-and-hold arrangement. *See In the Matter of Stewart Parness*, Accounting and Auditing Enforcement Rel. No. 108 (Aug. 5, 1986), Staff Accounting Bulletin 104, *Revenue Recognition.*

137. On November 30, 2009, Brad Foote placed 30 sets into a bill-and-hold arrangement similar to the one entered with Customer 2 in October 2009. Fifteen of these 30 sets completed the pull-ahead arrangement with Customer 2, and Brad Foote documented Customer 2's request through the same email authorizing delivery in October 2009. The other half corresponded to an additional 15 sets not formally ordered by Customer 2 until December 2009. In total, Brad Foote recognized $1,194,471 of revenue associated with these 30 sets. As with the October 2009 shipment, Broadwind failed to produce evidence of Customer 2's substantial business purpose for the arrangement and failed to comply with other requirements of a proper bill-and-hold arrangement.

**c. Koeppel's Audit of the Bill-and-Hold Arrangement**

138. Grant Thornton never learned the details of the bill-and-hold arrangement. During the 2009 year end audit, Grant Thornton identified the October 2009 transaction as a transaction for further review. However, the engagement team's testing of this transaction was limited to obtaining a summary of its terms from management. The summary failed to identify several aspects of the transaction critical to its proper accounting, including, among other things, the price discount and the inventory carrying cost. For example, interviews with Brad Foote personnel, review of documents associated with the transaction, or confirming the terms directly with Customer 2 could have revealed that the bill-and-hold arrangement was the product of a large-scale pull-ahead agreement and had no independent business purpose.

139. More broadly, prior to the conclusion of the audit, management identified multiple problematic transactions at Brad Foote designed to meet monthly revenue covenants during a pending offering. These transactions included improperly recorded bill-and-hold transactions that should have raised additional questions about the October 2009 transaction with Customer 2. The engagement team did not document how it altered the nature, timing, or extent of its audit procedures in a manner that addressed this risk.

140. Koeppel participated in the audit planning process and fraud brainstorming discussion, signed off on the audit working papers in which the identified risks were documented, and signed off on working papers concluding that the Customer 2 bill-and-hold transaction met applicable revenue recognition criteria.

**d. Retention of Supporting Documentation in the Audit File**

141. As discussed above, Broadwind identified and corrected certain transactions in which it had improperly recognized revenue through an internal review conducted by management from late 2009 to early 2010. A report of the internal review provided to Grant Thornton and referenced in its working papers identified multiple instances of improper revenue recognition,

which included backdated letters, side agreements, unauthorized bill-and-hold transactions, and a directive not to record a credit memo. These transactions contributed to an overstatement of revenue that enabled Brad Foote to barely meet its debt covenants in the months leading to a critical stock offering. However, the engagement team did not retain a copy of the report or supporting documentation for the questionable transactions in the audit file.

## E. VIOLATIONS

RULE 102(e) AND SECTION 4C OF THE EXCHANGE ACT

142. The 2009, 2010, and 2011 audits of ALC, and third quarter review and year end audit of Broadwind were deficient and not performed in accordance with PCAOB standards.[8] Section 4C(b) and Rule 102(e)(1)(iv) define improper professional conduct with respect to persons licensed to practice as accountants. Pursuant to these provisions, "improper professional conduct" includes two types of negligent conduct: (1) a single instance of highly unreasonable conduct that results in a violation of professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted; or (2) repeated instances of unreasonable conduct, each resulting in violations of professional standards, that indicate a lack of competence.

143. As set forth above, Koeppel and Robinson knew, or should have known, that the Ventas financial covenant calculations were an area in which heightened scrutiny was warranted in connection with the 2009, 2010 and 2011 audits of ALC. Moreover, Koeppel and Robinson knew or should have known facts that called into question ALC's claims that it was meeting the Ventas lease covenants by virtue of an agreement with Ventas to include employees and other non-residents in the covenant calculations. Throughout the 2009, 2010, and 2011 audits and reviews, Koeppel and Robinson were aware of repeated red flags surrounding ALC's practice of meeting the covenants by treating employees and other non-residents as occupants of the Ventas facilities. In light of these red flags, Koeppel and Robinson failed to take reasonable steps to verify that an agreement with Ventas existed or that the employees ALC claimed to be occupants of the facilities were in fact staying there. Had Koeppel and Robinson taken such measures, they could have exposed and put an end to ALC's fraud. Instead, Grant Thornton issued audit reports in 2009, 2010, and 2011containing unqualified opinions that were filed with ALC's financial statements in the Form 10-Ks. In those reports, Grant Thornton inaccurately stated that the audit had been conducted in accordance with PCAOB standards and that ALC's financial statements presented fairly, in all material respects, the company's position and results in conformity with accounting principles generally accepted in the United States of America.

[8] References to auditing standards in this Order are to PCAOB standards in effect at the time the audit work was performed. For example, the PCAOB risk assessment standards (AS 8-15) became effective for audits of fiscal years beginning on or after December 15, 2010 (*i.e.*, the 2011 audit of ALC) and superseded AU §§ 311, 312, 326, among others.

144. Further, in the course of Grant Thornton's 2009 third quarter review of Broadwind, Koeppel knew, or should have known, that Broadwind's financial statements omitted a $58 million impairment charge associated with its deteriorated customer relationships for Brad Foote's two most important customers. Additionally, in the course of the 2009 year end audit of Broadwind, Koeppel knew or should have known that Broadwind's impairment charge was not a fourth-quarter event and that Broadwind's third and fourth quarter financial statements materially overstated revenue.

*Failure to Properly Plan the Audit (AU §§ 311 and 312, AS 8, AS 9)*

145. PCAOB standards require an auditor to consider the nature, extent and timing of work to be performed in planning the audit and prepare a written audit program which sets forth in reasonable detail the audit procedures necessary to accomplish the audit objectives. (AU § 311.05). Auditors must also consider audit risk and materiality in planning the audit and designing audit procedures. (AU § 312.12). Auditors additionally must plan the audit so that audit risk will be limited to a low level appropriate for expressing an opinion on the financial statements. (AU § 312.13). Auditors are also required to consider significant risk of material misstatement of the financial statements in: (1) determining the nature, timing or extent of procedures; (2) assigning staff; and (3) requiring appropriate levels of supervision. (AU § 312.17). In planning an audit, auditors must also design procedures to obtain reasonable assurance of detecting misstatements that the auditor believes could be material. (AU § 312.25, AS 8.3).

146. PCAOB standards also require auditors to properly plan their audits and develop and document an audit plan that includes a description of, among other things: (1) the planned nature, timing and extent of substantive procedures; and (2) other planned audit procedures required to be performed so that the engagement complies with PCAOB standards. (AS 9.4, AS 9.10).

147. As a result of their conduct described above, Koeppel and Robinson failed to properly plan the 2009, 2010 and 2011 audits of ALC.

*Failure to exercise due professional care and professional skepticism (AU §§ 230, 316, 722, and AS 13)*

148. PCAOB standards require auditors to exercise due professional care in the planning and performance of the audit and the preparation of the report. (AU § 230.01). Auditors must maintain an attitude of professional skepticism, which includes "a questioning mind and a critical assessment of audit evidence." (AU § 230.07, AS 13.7). In addition, the auditor should "consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process." (AU § 230.08). In exercising professional skepticism, an auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest. (AU §§ 230.09 and 316.13). Further, auditors should: (1) perform an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to

fraud has occurred; and (2) conduct the engagement with a mindset that recognizes that a material misstatement due to fraud could be present, regardless of past experience with the entity and the auditors' belief about management's honesty and integrity. (AU § 316.13). Auditors should also exercise due professional care and professional skepticism in the course of reviews of interim financial information. (AU § 722.01).

149. As a result of their conduct described above, Koeppel and Robinson failed to exercise due professional care and professional skepticism in the 2009, 2010 and 2011 audits of ALC, and Koeppel failed to exercise due professional care and professional skepticism in the 2009 third quarter review and year end audit of Broadwind.

*Failure to obtain sufficient evidence (AU §§ 326 and 333, AS 13, 14 and 15)*

150. PCAOB standards required auditors to obtain sufficient competent evidential matter (for the 2009 Broadwind audit and the 2009 and 2010 ALC audits) and sufficient appropriate audit evidence (for the 2011 ALC audit) to afford a reasonable basis for an opinion with respect to the financial statements under audit. (AU § 326.22, AS 15.4). Auditors must be thorough in their search for evidential matter and unbiased in its evaluation and consider relevant evidential matter regardless of whether it corroborates or contradicts assertions in the financial statements. (AU § 326.25, AS 15.2 and 15.29).

151. PCAOB standards also provide that management representations "are not a substitute for the application of th[e] auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit," that "the auditor obtains written representations from management to complement other auditing procedures," and that "[i]n exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest." (AU §§ 333.02, 333.03, 230.09). Auditors must also: (1) obtain corroboration for management's explanation regarding significant unusual or unexpected transactions, events, amounts or relationships; and (2) perform procedures if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise or not at a sufficient level of detail to be useful. (AS 14.8).

152. Auditors should also design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure. (AS 13.8). In designing such audit procedures, auditors should obtain more persuasive audit evidence the higher the auditor's assessment of risk. (AS 13.9). Auditors should also perform substantive procedures, including tests of details, for significant risks, and the evidence auditors obtain from substantive procedures should increase as the assessed risk of material misstatement increases. (AS 13.11, AS 13.37).

153. As a result of their conduct described above, Koeppel and Robinson failed to obtain sufficient evidence supporting assertions in ALC's 2009, 2010 and 2011 Form 10-K financial statements that ALC was in compliance with the Ventas lease covenants. In the course of the 2009 year end audit of Broadwind, Koeppel also failed to obtain sufficient evidence supporting

the conclusion that the impairment was a fourth-quarter event and that the Customer 2 bill and hold transaction met the applicable revenue recognition criteria.

*Failure to Properly Supervise the Engagement Team (AU § 311 and AS 10)*

154. PCAOB standards note that audit "assistants," including firm personnel other than the auditor with final responsibility for the audit, are to be "properly supervised." (AU §§ 311.01 and 311.02). Those standards further require that assistants be informed of their responsibilities and the objectives of procedures assigned to them, and that the work of assistants be reviewed to determine whether it was adequately performed. (AU §§ 311.12, 311.13, and AS 10.5).

155. As a result of their conduct described above, Koeppel and Robinson failed to properly supervise the engagement team on the 2009, 2010 and 2011 ALC engagements.

*Failure to Make Additional Inquires or Perform Additional Procedures in the Course of Reviewing Interim Financial Information (AU § 722)*

156. PCAOB standards provide:

> If, in performing a review of interim financial information, the accountant becomes aware of information that leads him or her to believe that the interim financial information may not be in conformity with generally accepted accounting principles in all material respects, the accountant should make additional inquiries or perform other procedures that the accountant considers appropriate to provide a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information.

(AU § 722.22).

157. As a result of Koeppel's conduct described above, Koeppel violated AU § 722.22 when she failed to make appropriate additional inquires or perform other procedures in the course of the third quarter 2009 review of Broadwind's impairment assessment.

*Failure to Prepare Required Documentation (AS 3)*

158. PCAOB standards mandate that an auditor's documentation contain sufficient information to enable an experienced auditor, having no previous connection to the engagement to: (1) understand the nature, timing, extent and results of the procedures performed, evidence obtained and conclusions reached; and (2) determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review. (AS 3.1, 3.6). Auditors are also required to document significant findings and issues, including the actions taken to address them and the basis for the conclusions reached. (AS 3.12).

159. As a result of their conduct described above, Koeppel and Robinson failed to obtain required audit documentation on the 2009, 2010 and 2011 audits of ALC, and Koeppel failed to obtain required audit documentation on the 2009 year end audit of Broadwind.

*Finding*

160. As a result of the conduct described above, the Commission finds that Koeppel and Robinson engaged in improper professional conduct within the meaning of Sections 4C(a)(2) and 4C(b)(2) of the Exchange Act and Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B) of the Commission's Rules of Practice. Koeppel's conduct in the 2009 and 2010 audits of ALC and 2009 third quarter review and year end audit of Broadwind, and Robinson's conduct in the 2011 audit of ALC, involved repeated instances of unreasonable conduct, each resulting in violations of PCAOB standards and indicating a lack of competence, and also satisfies the standard of highly unreasonable conduct resulting in violations of PCAOB standards in circumstances in which heightened scrutiny was warranted.

KOEPPEL AND ROBINSON WERE CAUSES OF VIOLATIONS OF SECTION 13(a) OF THE EXCHANGE ACT AND RULE 13a-1 THEREUNDER, AND KOEPPEL ALSO CAUSED A VIOLATION OF EXCHANGE ACT RULE 13a-13

161. Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require that every issuer of a security registered pursuant to Section 12 of the Exchange Act file with the Commission annual and quarterly reports (i.e., Forms 10-K and 10-Q) as the Commission may require. The obligation to file such reports embodies the requirement that they be true and correct.

162. ALC's annual reports on Form 10-K for fiscal years 2009, 2010 and 2011 included audit reports from Grant Thornton that stated its audits of ALC's financial statements were conducted "in accordance with the standards of the Public Company Accounting Oversight Board" and that ALC's financial statements presented fairly, in all material respects, the company's position and results. Broadwind's 2009 Form 10-K contained a similar representation by Grant Thornton. These statements were materially misleading. As a result of Koeppel's and Robinson's above-described conduct, Grant Thornton's 2009, 2010 and 2011 audits of ALC and 2009 audit of Broadwind were not conducted in accordance with PCAOB standards and the financial statements included in ALC's 2009, 2010 and 2011 Forms 10-K were materially misstated because, among other things, they incorrectly represented that ALC was in compliance with the Ventas lease financial covenants. As for Broadwind, its Form 10-Q for the third quarter of 2009 materially overstated its intangible assets and understated a material impairment charge, and its 2009 10-K misstated revenue and incorrectly described its $58 million impairment charge as a fourth quarter event. At a minimum, Koeppel knew or should have known that her unreasonable conduct would contribute to ALC's filing of inaccurate 2009 and 2010 Forms 10-K and Broadwind's filing of an inaccurate third quarter 2009 Form 10-Q and 2009 Form 10-K, and Robinson knew or should have known that his unreasonable conduct would contribute to ALC's filing of an inaccurate 2011 Forms 10-K.

163. As a result of the conduct described above, the Commission finds that Koeppel was a cause of ALC's violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder and Broadwind's violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, and that Robinson was a cause of ALC's violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder.

## IV.

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, it is hereby ORDERED, effective immediately, that:

A. Pursuant to Section 21C of the Exchange Act, Koeppel shall cease and desist from committing or causing any violations and any future violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, and Robinson shall cease and desist from committing or causing any violations and any future violations and any future violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder.

B. Koeppel is denied the privilege of appearing or practicing before the Commission as an accountant.

1. After five years from the date of this Order, Koeppel 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:

a. 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 Koeppel's work in his 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

b. an independent accountant. Such an application must satisfy the Commission that:

(1) Koeppel, or the public accounting firm with which she is associated, is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(2) Koeppel, or the registered public accounting firm with which she is associated, has been inspected by the PCAOB and that inspection did

not identify any criticisms of or potential defects in his or the firm's quality control system that would indicate that Koeppel will not receive appropriate supervision;

(3) Koeppel, has resolved all disciplinary issues with the PCAOB, and has complied with all terms and conditions of any sanctions imposed by the PCAOB (other than reinstatement by the Commission); and

(4) Koeppel acknowledges her responsibility, as long as Koeppel appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the PCAOB, including, but not limited to, all requirements relating to registration, inspections, engagement quality review, and quality control standards.

2. The Commission will consider an application by Koeppel to resume appearing or practicing before the Commission provided that her CPA license is current and she has resolved all other disciplinary issues with the applicable boards of accountancy. However, if CPA 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 Koeppel's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

C. Robinson is denied the privilege of appearing or practicing before the Commission as an accountant.

1. After two years from the date of this Order, Robinson 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:

a. 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 Robinson'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

b. an independent accountant. Such an application must satisfy the Commission that:

(1) Robinson, or the public accounting firm with which he is associated, is registered with the PCAOB in accordance with the Sarbanes-Oxley Act of 2002, and such registration continues to be effective;

(2) Robinson, or the registered public accounting firm with which he is associated, has been inspected by the PCAOB and that inspection did not identify any criticisms of or potential defects in his or the firm's quality control system that would indicate that Robinson will not receive appropriate supervision;

(3) Robinson, has resolved all disciplinary issues with the PCAOB, and has complied with all terms and conditions of any sanctions imposed by the PCAOB (other than reinstatement by the Commission); and

(4) Robinson acknowledges his responsibility, as long as Robinson appears or practices before the Commission as an independent accountant, to comply with all requirements of the Commission and the PCAOB, including, but not limited to, all requirements relating to registration, inspections, engagement quality review, and quality control standards.

2. The Commission will consider an application by Robinson to resume appearing or practicing before the Commission provided that his CPA license is current and he has resolved all other disciplinary issues with the applicable boards of accountancy. However, if CPA 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 Robinson's character, integrity, professional conduct, or qualifications to appear or practice before the Commission.

D. Respondents shall each, within 14 days of the entry of this Order, pay the civil money penalties indicated below to the Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3):

(i) $10,000 for Koeppel; and
(ii) $2,500 for Robinson.

If timely payment is not made additional interest shall accrue pursuant to 31 U.S.C. 3717. Payments ordered in this paragraph must be made in one of the following ways:

(1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondents 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) Respondents 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 Koeppel or Robinson 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 Robert Burson, Associate Regional Director, Chicago Regional Office, Securities and Exchange Commission, 175 W. Jackson Blvd, Suite 900, Chicago, IL 60604.

## V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
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. 76536 / December 2, 2015**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3718 / December 2, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16976**

| | |
|---|---|
| **In the Matter of**<br><br>**Grant Thornton, LLP,**<br><br>**Respondent.** | **ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER** |

**I.**

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice[2] against Grant Thornton, LLP ("Grant Thornton" or "Respondent").

[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (2) . . . to have engaged in unethical or improper professional conduct.

[2] Rule 102(e)(1) provides, in relevant part:

> The Commission may censure a person . . . who is found . . .
>
> * * *
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> (ii) to have engaged in unethical or improper professional conduct.

## II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer ~~of Settlement ("Offer") that the Commission has determined to accept. Respondent admits the~~ facts set forth in Sections III.B, C, and E through F below, acknowledges that its conduct in the course of its Assisted Living Concepts, Inc. and Broadwind Energy, Inc. engagements violated the federal securities laws, admits the Commission's jurisdiction over it and the subject matter of these proceedings, and consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (the "Order"), as set forth below.

## III.

On the basis of this Order and Respondent's Offer, the Commission finds[3] that:

### A. SUMMARY

1. This matter involves improper professional conduct by Grant Thornton while serving as the auditor of two clients of Grant Thornton's Wisconsin practice: Assisted Living Concepts, Inc. ("ALC"), a publicly traded senior living company, and Broadwind Energy, Inc. ("Broadwind"), a publicly traded alternative energy company. During the course of its engagements, Grant Thornton repeatedly violated professional standards while ignoring repeated red flags and fraud risks that allowed ALC and Broadwind to file numerous reports with the Commission that were materially false and misleading.

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> (iv) with respect to persons licensed to practice as accountants, "improper professional conduct" under Rule 102(e)(1)(ii) means:
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> * * *
>
> (B) either of the following two types of negligent conduct:
>
> > (1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted.
> >
> > (2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

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

2. For the ALC engagement, for more than three years and under the leadership of two engagement partners, Grant Thornton failed to identify a fraud perpetrated by ALC's CEO and CFO. That long-running fraud was designed to mask ALC's defaults on certain occupancy and revenue covenants that had significant financial consequences for ALC in the event of non-compliance. As a result of the fraud and Grant Thornton's failed audits, for three years ALC falsely represented to its investors that it was meeting the covenants and avoiding the serious ramifications of the defaults.

3. For the Broadwind engagement, Grant Thornton's failure to exercise due professional care and skepticism contributed to Broadwind improperly omitting from its financial statements that it had sustained a $58 million impairment charge caused by the severe deterioration of customer relationships for two of Broadwind's most important customers. Grant Thornton's failures also contributed to Broadwind conducting a public offering for its stock which concealed this impairment charge from investors. Grant Thornton's negligence further contributed to Broadwind filing multiple financial statements which materially overstated revenue to Broadwind's investors.

4. Grant Thornton's failed ALC and Broadwind engagements were indicative of systemic quality issues and failures to adhere to professional standards on engagements of clients of Grant Thornton's Wisconsin practice. In particular, Grant Thornton had received numerous warnings of quality issues involving the managing partner of the Wisconsin practice. Despite these warnings, Grant Thornton allowed that managing partner to continue to audit public companies, including ALC and Broadwind, and failed to take the appropriate remedial steps that could have stopped ALC's and Broadwind's repeated false and misleading statements to their investors.

## B. RESPONDENT

5. **Grant Thornton** is an Illinois limited liability partnership and a PCAOB-registered public accounting firm with its headquarters in Chicago, Illinois. The conduct at issue occurred in the course of audits and reviews of clients of Grant Thornton's Wisconsin practice.

## C. RELEVANT GRANT THORNTON PROFESSIONALS

6. **Melissa K. Koeppel** ("Koeppel"), age 54, is a Certified Public Accountant ("CPA") licensed to practice in Wisconsin. Koeppel served as the managing partner of Grant Thornton's Wisconsin practice from 2008 through April 2011. Koeppel served as the Grant Thornton engagement partner on, and had final audit responsibility over, the ALC engagements from 2006 through 2010 and the Broadwind engagements from 2007 through the second quarter of 2010. Since 2012, Koeppel has been employed by Grant Thornton as a managing director, outside the audit-services practice.

7. **Jeffrey J. Robinson** ("Robinson"), age 63, is a CPA licensed to practice in Illinois and Wisconsin. Robinson served as the managing partner of Grant Thornton's Wisconsin practice from April 2011 through July 2015, when he retired. Robinson served as the Grant Thornton engagement partner on, and had final audit responsibility over, the ALC engagements from 2011

through the first quarter of 2013, when ALC terminated its relationship with Grant Thornton upon ALC's acquisition by another company.

## D. OTHER RELEVANT ENTITIES

8. **ALC** was a Nevada corporation with its principal place of business in Menomonee Falls, Wisconsin. Between November 2006 and July 2013, ALC's common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act and traded on the New York Stock Exchange. In February 2013, ALC agreed to be sold to a global private equity firm. In July 2013, when the sale was completed, ALC's stock ceased trading on the NYSE.

9. **Broadwind** is an alternative energy company incorporated in Delaware and headquartered in Cicero, Illinois. In October 2007, Broadwind purchased Brad Foote Gear Works, Inc. ("Brad Foote") to provide gear systems for the wind turbine and other energy industries. Broadwind's common stock was quoted on the OTC Bulletin Board until April 9, 2009, when its common stock began trading on the NASDAQ Global Select Market. Broadwind's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act. On February 5, 2015, the Commission filed a settled action in the Northern District of Illinois against Broadwind and its former CEO and CFO for Broadwind's failure to record and disclose a $58 million impairment charge prior to a public offering in January 2010. The SEC also charged Broadwind and its officers with violations arising from accelerated revenue recognition practices and inadequate disclosures ahead of the offering. Broadwind consented to a judgment enjoining it from violating Section 17(a)(2) of the Securities Act and 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 imposing a civil penalty of $1 million. The former CEO and CFO also consented to a judgement that enjoined them from future securities laws violations, and imposed disgorgement, prejudgment interest, and civil penalties. The district court entered the proposed judgments associated with the settlement on February 11, 2015. *See SEC v. Broadwind Energy, Inc., et al.*, Case No. 15-cv-1142 (N.D. Ill.).

## E. GRANT THORNTON'S AUDITS AND REVIEWS OF ALC

### 1. ALC and the Ventas Lease

10. During the relevant time period, ALC operated more than 200 senior living residences in the United States, totaling more than 9,000 units. On January 1, 2008, ALC purchased the operations of eight assisted living facilities for a total of 540 units in Alabama, Florida, Georgia, and South Carolina (the "Ventas facilities") and simultaneously entered into a lease with Ventas, Inc. ("Ventas"), a publicly traded real estate investment trust ("REIT") and the owner of the facilities, to operate the facilities (the "Ventas lease").

11. The Ventas lease contained financial covenants (the "financial covenants"), which required that ALC maintain certain quarterly and trailing twelve-month occupancy percentages and coverage ratios, both at each facility and at the portfolio level. The lease defined "coverage ratio" as cash flow divided by rent payments. The Ventas lease required ALC to demonstrate its compliance with the financial covenants on a quarterly basis by providing Ventas, within 45 days of the end of each quarter: (1) facility financial statements prepared in accordance with general

accepted accounting principles ("GAAP"); (2) schedules documenting compliance with the financial covenants; and (3) an officer's certificate, signed by an ALC executive, attesting to the completeness and accuracy of such information.

~~12. The lease provided that if ALC violated any of the financial covenants, Ventas~~ could: (1) terminate the lease in its entirety; (2) evict ALC from all eight facilities; and (3) require ALC to pay accelerated rent equal to the net present value of the unpaid rent for the remaining term of the lease. ALC disclosed the net present value of its unpaid rent, as of its 2009, 2010, and 2011 fiscal year-end, to have been approximately $24.9 million, $20.9 million and $16.7 million respectively. The lease also provided that it could only be modified by a writing signed by authorized representatives of both ALC and Ventas and that all "notices, demands, requests, consents, approvals and other communications" under the lease were to be in writing with a copy to Ventas's general counsel. Other provisions of the lease required ALC to use the Ventas facilities solely for their primary intended use and in a manner consistent with their operation as healthcare facilities.

### 2. ALC's Fraudulent Scheme to Hide the Covenant Defaults

13. Beginning in 2008, shortly after ALC entered the Ventas lease, occupancy at the Ventas facilities declined sharply. As a result of the occupancy declines, from at least the first quarter of 2009 through the fourth quarter of 2011, ALC failed, by a significant margin, many of the occupancy and coverage ratio covenants contained in the Ventas lease. Nevertheless, in each Form 10-K and 10-Q ALC filed during that period, ALC falsely represented that it was in compliance with the Ventas lease financial covenants. ALC also disclosed that non-compliance with the financial covenants could result in a "material adverse impact" on ALC. Moreover, beginning with the second quarter of 2011, ALC falsely represented in its 2011 Forms 10-K and 10-Q that "it did not believe that there is a reasonably likely degree of risk of breach of the [Ventas] covenants." ALC included this additional disclosure in response to a comment letter received from the Commission's Division of Corporation Finance.

14. To hide ALC's failure to comply with the covenants from Ventas, ALC's CEO, Laurie Bebo, and CFO, John Buono, directed ALC accounting personnel to include in the covenant calculations between 49 and 103 fabricated occupants for every day from July 2009 through December 2011.[4] To establish the number of fabricated occupants to be included in the covenant

[4] On December 3, 2014, the Commission instituted public administrative and cease and desist proceedings against Bebo and Buono, alleging violations of the antifraud, books and records, internal controls, reporting, and other provisions of the Exchange Act. *In the Matter of Laurie Bebo and John Buono, CPA*, Exchange Act. Release No. 73722. On January 29, 2015, the Commission entered an Order accepting Buono's offer of settlement, finding that he violated each securities law provision alleged against him, imposing a $100,000 civil penalty, and barring Buono from practicing before the Commission as an accountant or serving as an officer or director of a public company. Exchange Act Release No. 74177. On October 2, 2015, following a four-week evidentiary hearing, an Administrative Law Judge issued an Initial Decision making findings against Bebo. Initial Decision Release No. 893.

calculations, ALC accounting personnel, at Bebo's and Buono's direction, reverse-engineered the requisite number of additional occupants needed to meet the covenants each quarter. ALC accounting personnel also prepared monthly journal entries to record revenue associated with the fabricated occupants which: (1) credited the fabricated occupant revenue to the individual Ventas facilities; and (2) debited revenue in the same amount in a corporate revenue account.[5] Shortly after the end of each quarter, ALC provided Ventas with covenant calculations which included the fabricated occupants in the occupancy covenant calculations and the revenue associated with the fabricated occupants in the coverage ratio calculations and thus falsely showed that ALC was meeting the covenants.

15. Bebo and Buono told Grant Thornton that Ventas had agreed that ALC could include in the covenant calculations ALC employees who travelled to and stayed at the Ventas facilities for business purposes.[6] However, in actuality, no such agreement existed and Ventas was never told that any ALC employees were being included in the covenant calculations. Even if Ventas had agreed that ALC could include in the covenant calculations employees who actually stayed at the Ventas facilities, given that only a small number of ALC employees actually did so, ALC would still have missed the covenants by significant margins.

16. In the third quarter of 2009, Grant Thornton asked ALC to identify the employees included in the covenant calculations. In response, Bebo created and provided Grant Thornton with a list identifying the employees and their associated lengths of stay at the Ventas facilities. Bebo would subsequently prepare and/or approve such a list for Grant Thornton for every quarter through the fourth quarter of 2011. However, given the small number of ALC employees that actually stayed at the Ventas facilities and the large number of fabricated occupants necessary to meet the covenants, Bebo chose to include on the list: (1) her family members and friends; (2) family members (including the seven-year old nephew) of another ALC executive; (3) employees who did not travel to, let alone stay at, the facilities; (4) employees of the Ventas facilities, who lived nearby and did not stay overnight at those facilities; (5) employees who had been terminated by ALC or employees who ALC anticipated hiring but who had not yet started; (6) various ALC employees as occupants of multiple Ventas facilities for the same time period; and (7) other individuals who were neither ALC employees nor residents of the Ventas facilities. ALC did not disclose any of this to Ventas.

17. The fraudulent scheme unraveled in the spring of 2012. In April 2012, Ventas, which was still unaware of ALC's use of employees in the covenant calculations, filed a lawsuit against ALC resulting from ALC's unrelated failure to meet state regulatory requirements. The

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[5] As a result, ALC eliminated in consolidation the revenue associated with the fabricated occupants, and such revenue was not reported in its Commission filings. In addition, ALC did not include the fabricated occupants in the occupancy numbers reported in its Commission filings.

[6] ALC's practice of including in the covenant calculations employees or other non-residents is sometimes referred to hereafter as "the employee adjustment."

following day, Bebo sent Ventas a settlement proposal pursuant to which Ventas would release ALC from liability for all claims including those arising from ALC including employees in the covenant calculations. The settlement proposal was the first time Ventas learned that ALC was including employees in the covenant calculations. On May 9, 2012, Ventas issued a notice of default in which it accused ALC of fraud based on the employee adjustment.

18. In the meantime, on May 2, 2012, one of ALC's accounting personnel filed a whistleblower complaint with the audit committee of ALC's Board of Directors. The complaint described the employee adjustment as a "sham" and disclosed that ALC had included in the covenant calculations: (1) employees who did not travel to the Ventas facilities; (2) certain employees at multiple facilities on the same day; and (3) Bebo's parents, husband, and a family friend. ALC immediately initiated an internal investigation, and Bebo was terminated shortly thereafter, purportedly for reasons unrelated to the employee adjustment.

19. In June 2012, ALC and Ventas settled their lawsuit. As part of the settlement, ALC purchased the Ventas facilities and certain other facilities from Ventas for an amount far greater than the appraised value of the facilities. ALC paid approximately $100 million to settle the litigation and purchase the facilities, even though independent appraisals only valued the purchased facilities at $62.8 million. Thus, in its second quarter 2012 interim financial statements, ALC included as an expense $37.2 million for "lease termination and settlement" and also wrote off the entirety of the remaining operating lease intangible assets associated with the Ventas facilities, which totaled approximately $8.96 million.

20. Grant Thornton issued audit reports containing unqualified opinions on ALC's 2009, 2010 and 2011 financial statements. Each of those financial statements falsely disclosed that ALC was in compliance with the financial covenants. Those audit reports and financial statements were included in ALC's Form 10-K Commission filings.

### 3. In Connection with the 2009, 2010, and 2011 ALC Engagements, Grant Thornton Was Aware of Numerous Risks and Red Flags Related to ALC's Covenant Calculation Practices

21. ALC was one of the larger clients for Grant Thornton's Wisconsin practice.

#### a. The 2009 Engagement

22. By the beginning of Grant Thornton's 2009 engagement, Koeppel and other members of the engagement team were aware that occupancy at the Ventas facilities had declined and that ALC was close to defaulting on the financial covenants. For this reason, in connection with its planning meeting for the first quarter 2009 review, the ALC engagement team focused on the financial covenants. The planning meeting agenda, which Koeppel reviewed, indicated that the Ventas covenant calculations were an area to which the engagement team should "devote special attention" and that the engagement team should "look closely" at ALC's covenant calculations.

23. Three weeks later, in late April 2009, ALC accounting personnel sent a Grant Thornton junior engagement team member ALC's calculations of the occupancy and coverage

ratio covenants for the quarter and underlying support for the numbers used in the covenant calculations. Shortly thereafter, the engagement team member noticed discrepancies for six of the eight Ventas facilities between the occupancy figures used in the covenant calculations and the underlying support. As a result, he sent an email to ALC accounting personnel asking for an explanation for the discrepancies.

24. In response, ALC accounting personnel emailed Grant Thornton a spreadsheet known as an "occupancy recon" which listed for each of the Ventas facilities for each month during the quarter: (1) the actual occupancy of the facilities; and (2) the number of ALC "employees" which were added to the actual occupancy numbers for purposes of the covenant calculations. The occupancy recon revealed that ALC was adding a total of 24 "employees" into the occupancy calculations for every day in the quarter. A review of the information contained therein would have shown that ALC failed certain occupancy covenants without the inclusion of employees.

25. ALC accounting personnel also provided the junior engagement team member with purported "support" for the employee adjustment, which was a February 4, 2009 email from Bebo to a Ventas employee (the "February 4 email"). However, the February 4 email made no mention of the financial covenants, and merely mentioned that ALC may rent rooms at the Ventas facilities to certain of its employees "in the ordinary course of business." The junior engagement team member elevated the issue to Grant Thornton's engagement manager, yet Grant Thornton did not receive any additional support from ALC. The engagement team told Koeppel about the employee adjustment and described it as unusual, but told Koeppel that the team had reviewed documentation which the team believed evidenced an agreement with Ventas. However, Koeppel never reviewed that documentation nor attempted to learn other details about it.

26. Grant Thornton did not perform additional procedures, such as seeking confirmation from Ventas that it had agreed to the use of employees in the covenant calculations. In fact, Grant Thornton would never seek confirmation from Ventas that it had agreed to the use of employees in the covenant calculations. Had Grant Thornton done so, it would have confirmed that Ventas never agreed to the employee adjustment.

27. Grant Thornton's workpapers for the first quarter of 2009 do not contain the February 4 email or reference ALC's inclusion of employees in the covenant calculations. The workpapers do reflect that Grant Thornton determined that ALC passed the covenant calculations based on the adjusted numbers contained in the occupancy recons.

28. ALC's management representation letter to Grant Thornton for the first quarter of 2009 and every quarterly review and audit in fiscal year 2009, 2010 and 2011 contained a representation that ALC had complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

29. In the course of Grant Thornton's second quarter 2009 review, a Grant Thornton summer intern was tasked with performing the procedures with respect to ALC's compliance with the Ventas lease covenants under the supervision of an audit senior. The intern reviewed an occupancy recon showing that ALC was including approximately 23 employees in the covenant

calculations for every day of the quarter. The intern then prepared a note to the workpapers referencing the employee adjustment, which included language from the February 4 email, and stated:

> ~~The employee adjustment relates to extra rooms at each facility not currently~~ occupied by ALC residents. The rooms are subleased through ALC to improve the overall performance of each facility...Since the units are subleased, an adjustment is needed to show ALC occupancy and for Ventas testing.

Koeppel signed off on this workpaper, even though she knew there were no formal sublease agreements for any employee-occupied rooms.

30. For the third quarter of 2009, Grant Thornton reviewed occupancy recons showing that ALC had included 45, 65 and 75 employees for each day of July, August and September respectively. At Koeppel's request, the occupancy recons now included a list showing the names of the ALC employees purportedly staying at each Ventas facility, and the attendant length of their purported stay. This information would be contained in each subsequent occupancy recon, which showed employees staying at the facilities for every day of each month they were listed as an occupant. Koeppel never instructed the engagement team to perform additional procedures related to the list of names to determine whether the list of employees, or the length of the employees' purported stays, was accurate or appropriate. Moreover, Koeppel never asked the engagement team what procedures, if any, the team was performing with respect to the list of names. Had Koeppel, or later Robinson, asked the engagement team to perform substantive procedures on the list of names, Grant Thornton would have discovered that the list was fraudulent.

31. As part of its third quarter review, Grant Thornton, requested that ALC include in its representation letter the representation that ALC had "calculated the [Ventas] lease covenants in accordance with the corresponding lease agreement and the lessor's instructions." The engagement team wanted this representation included in part because it was concerned about the employee adjustment. In response, ALC modified the requested representation, and included the following in its representation letter: "We have calculated the [Ventas] lease covenants in accordance with the corresponding lease agreement and *as understood by us after conferring with the lessor*." (Emphasis added). Grant Thornton's workpapers do not contain an explanation for the modification in the language.

32. Grant Thornton's workpapers for the third quarter 2009 review observed that one of the Ventas facilities had unexpected or unusual revenue trends in that changes in revenue could not be explained by corresponding changes in occupancy. The workpapers addressing these trends noted that a Grant Thornton junior engagement team member had spoken with ALC personnel who explained that: (a) ALC employees were staying at the Ventas facilities per an agreement with Ventas; and (b) that such employees "pay rent and increase revenue," but are not counted toward ALC's company-wide occupancy numbers. This notation in the workpapers, which Koeppel reviewed, conflicted with her understanding that ALC employees included in the covenant calculations did not pay rent.

33. In the course of Grant Thornton's 2009 year end audit, Koeppel reviewed risk assessment workpapers that she understood referred to risks associated with the Ventas financial covenants.

~~34. In connection with that audit, and in the subsequent 2010 and 2011 audits, Grant~~ Thornton documented that ALC was using "unusual" journal entries in connection with the employee adjustment. Those journal entries recorded "negative revenue" in a corporate revenue account to offset $1.2 million in non-GAAP revenue on the financial statements of the Ventas facilities associated with the employees included in the covenant calculations. The result of the offsetting revenue meant that the employee revenue reported to Ventas was eliminated from ALC's consolidated financial statements. Koeppel, and later Robinson, was aware of these unusual entries yet never instructed the engagement team to perform additional testing on the employee adjustment.

35. Also in connection with the 2009 year end audit, the Grant Thornton engagement team planned on conducting site visits to five Ventas facilities in Georgia and one in South Carolina to, among other things, verify facility occupancy figures, physically inspect the houses and the assets therein, make fraud inquiries with facility employees and review documentation that was maintained at the facilities. However, ALC requested that the engagement team choose other site visit locations in lieu of the Georgia facilities, and Koeppel acquiesced to ALC's request.

36. Koeppel also reviewed a workpaper detailing ALC's monthly revenues for each of its facilities. That workpaper also indicated the occupancy rates for each facility. The workpaper showed that the occupancy rate for seven of the eight Ventas facilities fell far short of the rates required by the lease covenants.

37. In the course of the 2009 year end audit, Grant Thornton reviewed occupancy recons showing that ALC was including 103 employees in the covenant calculations for each day of the fourth quarter, yet failed to mention the employee adjustment in the covenant calculation workpapers. Nevertheless, Koeppel signed off on those workpapers. In addition, Koeppel determined that a representation specific to the use of employees in the covenant calculations, such as the one included in the third quarter 2009 letter, was no longer necessary for ALC's representation letter. No such representation was included in the representation letters for any subsequent ALC audits and reviews in the relevant period.

**b. The 2010 Engagement**

38. In connection with its planning meeting for the first quarter 2010 review, Grant Thornton again focused on the financial covenants. The planning meeting agenda, which Koeppel reviewed, noted that the Ventas covenant calculations were an area to which the engagement team should "devote special attention" and that the engagement team should "make sure we are testing the [Ventas] lease covenant calculations."

39. For the first and second quarter 2010 reviews, Grant Thornton reviewed occupancy recons showing that ALC included 103 employees in the covenant calculations each day from January through May, and included 90 employees each day in June.

40. By the time Grant Thornton was conducting field work for the third quarter 2010 review, Grant Thornton national professional standards and risk management personnel had become aware of negative quality indicators with respect to Koeppel, who was placed on a November 2010 monitoring list for partners with such negative indicators. Grant Thornton placed Koeppel on this list because, among other things, her audit clients had restated their financial statements or interim financial information four times in the preceding two years. The Public Company Accounting Oversight Board ("PCAOB"), in its 2008 inspection report, had also found deficiencies on one of Koeppel's engagements because Grant Thornton had failed to gather sufficient audit evidence.

41. One of the restatements that led to Koeppel's inclusion on the partner monitoring list involved Grant Thornton's audit client, Koss Corporation ("Koss"). In June 2010, Koss restated its financial statements for the preceding two fiscal years because one of its vice presidents had embezzled $31.5 million from 2005 through 2009 and would plead guilty to criminal charges based on the misconduct. Koeppel was the engagement partner for the Koss audit for three of the four years of the embezzlement. In July 2012, Grant Thornton, without admitting any liability, paid $8.5 million to settle a malpractice case filed by Koss.

42. By November of 2010, Grant Thornton's National Professional Practice Director for the Midwest region ("NPPD") became aware of negative audit quality indicators with respect to Koeppel as a result of an ongoing PCAOB inspection. Although the NPPD did not know that Koeppel had been placed on the partner monitoring list, he was informed by others in the firm that Koeppel had a number of negative audit quality indicators. The NPPD also became aware of observations by other Grant Thornton partners that the Wisconsin practice, for which Koeppel was the managing partner, had "gotten off the tracks from a methodology perspective."

43. By the fall of 2010, Grant Thornton had removed Koeppel from all of her other public company engagements,[7] but decided to allow her to continue as the engagement partner for the 2010 ALC audit.

44. Following the completion of the second quarter 2010 review, the audit manager assigned to the ALC engagement team resigned. During the planning stages for the third quarter review, Grant Thornton assigned a new engagement manager (the "Engagement Manager") to be co-engagement manager on the ALC engagement. During the third quarter 2010 review, Koeppel became aware that the other Grant Thornton auditor assigned to be the co-manager of the ALC engagement was removed from the engagement. Koeppel knew that this left the Engagement Manager as the only manager on the ALC engagement.

45. The Engagement Manager's assignment as the sole engagement manager for the ALC engagement contravened Grant Thornton policy, which required that lead managers and partners on public company audit engagements be "SEC designated" to ensure that those

[7] Grant Thornton removed Koeppel from the remainder of her audit and review engagements, including private company engagements, after completing her work on financial statements or interim financial information for years or quarters ending December 31, 2010.

individuals had the appropriate level of experience and understanding about Commission requirements. To obtain such a designation, an auditor was required to spend 200 hours on public company engagements in a prescribed time period and complete certain continuing professional education courses.

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46. Koeppel knew that the Engagement Manager was not SEC designated due to the Engagement Manager having spent insufficient time on public company engagements. Koeppel also knew that the other Grant Thornton auditor assigned to be the co-manager of the ALC engagement, who was SEC designated, was removed from the engagement. Koeppel knew that this left the Engagement Manager, despite her lack of SEC designation, as the only manager on the ALC engagement.

47. On October 22, 2010, shortly after the Engagement Manager started working on the ALC engagement, one of her subordinates brought the issue of the inclusion of employees in the covenant calculations to the Engagement Manager's attention. The email the Engagement Manager received stated:

> You will also see that the only way some of the houses are passing [the occupancy] covenant is by having these [employee] adjustments. In prior quarters, as well as again this quarter, we have asked for support for these [employee] adjustments but they haven't [been] able to provide any. In prior quarters I have also asked if they have any support (letters, emails, etc. from [Ventas]) to show that [Ventas] is aware that ALC is adding in [employees] and is okay with it. They have nothing. [the Engagement Manager's predecessor manager] said that all we can do then is rep it... Since you are new to the job, I wanted to bring this to your attention and make sure you are comfortable with this as well. Is there anything else we should do with this?

48. A few days later, an engagement team member emailed the Engagement Manager a copy of the Ventas lease and noted that she could not locate any provisions that defined "occupancy." The Engagement Manager responded that she also could not find any such provisions and intended to contact ALC accounting personnel who prepared the covenant calculations for additional information. The Engagement Manager believed it was necessary to speak to ALC accounting personnel because ALC's inclusion of employees did not comport with the traditional definition of "occupancy" for assisted living facilities.

49. The Engagement Manager then spoke with the ALC accountant who prepared the occupancy recons. Based on this conversation, the Engagement Manager believed that ALC was possibly providing Ventas with the occupancy recons and that this allowed Ventas to discern that ALC was including employees in the covenant calculations. In an email documenting her conversation with the ALC accountant, the Engagement Manager wrote that the accountant "did say he gives [Ventas] the more detailed spreadsheet that we have, so he thinks if they had a problem with it, they would have said something." She added:

> If I can get John [Buono] to confirm this, then I think we can document that

> they receive [the occupancy recon], have opportunity to disagree, etc. I'd still like it in the rep letter too then. But at least I feel more comfortable that they see the detail.

50. The Engagement Manager then attempted to contact Buono, who was unavailable. The Engagement Manager left Buono a voicemail inquiring about ALC's use of employees in the covenant calculations. In that voicemail, the Engagement Manager noted that based on her conversation with the ALC accountant, she believed that "maybe" Ventas received the occupancy recons showing ALC's inclusion of employees. The Engagement Manager did not ask anyone at Grant Thornton to review the materials ALC sent to Ventas, which would have shown that Ventas was not receiving information showing ALC's use of employees. Grant Thornton would not perform such a review until the year end 2011 audit.

51. After leaving Buono the voicemail, the Engagement Manager spoke with Koeppel. Koeppel indicated to the Engagement Manager that Koeppel was aware that ALC had been including employees in the covenant calculations for the previous six quarters and that Koeppel was comfortable with the practice. Following this conversation, the Engagement Manager emailed Buono and told him to ignore the voicemail.

52. The Engagement Manager also suggested to Koeppel that ALC include in its representation letter a representation relating to ALC's use of employees in the covenant calculations, but Koeppel determined that such a representation was unnecessary.

53. Thus, the Engagement Manager was dissuaded by Koeppel from following either of the Engagement Manager's recommendations – speaking with Buono and obtaining additional representations – for obtaining support for ALC's use of employees in the covenant calculations.

54. In the course of the third quarter 2010 review, Grant Thornton for the first time included copies of the occupancy recons (without the employee names) in its workpapers. Those materials, which Koeppel and the Engagement Manager reviewed, showed that ALC was including between 68 and 72 employees in the Ventas covenant calculations for each day of the quarter.

55. Grant Thornton also included two notes in the workpapers regarding ALC's use of employees in the covenant calculation. In the first note, Grant Thornton indicated that, as a result of the employee adjustment, the occupancy figures used in the covenant calculations differed from the figures provided in ALC's internal occupancy reports. In the second note, Grant Thornton explained that the difference was, in part, the result of the employee adjustment and wrote that: "The employee adjustment relates to extra rooms at each facility that are not currently occupied by ALC residents, but are set aside for ALC employees to improve the overall performance of each facility." The note also contained the incorrect observation that Ventas was receiving the occupancy recons showing the number of included employees, and had the opportunity to disagree with ALC's practices.

56. In addition, Grant Thornton included the Ventas lease covenants in its Summary of Significant Matters ("the SSM") for the third quarter 2010 review. Grant Thornton prepared the

SSM to highlight to engagement partners and engagement quality reviewers, among others, important issues and questions encountered during the audit or review. In the SSM, Grant Thornton mistakenly noted that it had "confirmed" with Buono that Ventas received the occupancy recon. The SSM also noted that Grant Thornton was not able to "specifically test" ALC's use of employees in the covenant calculations, that Grant Thornton accordingly needed to rely on ALC's representations about its covenant practices, and that such a representation was included in ALC's representation letter.

57. Both Koeppel and the Engagement Manager reviewed the SSM. The Engagement Manager knew or should have known that the SSM incorrectly noted that Buono had represented that Ventas received the occupancy recons.

58. In advance of Grant Thornton's third quarter 2010 meeting with ALC's audit committee, the Engagement Manager added the Ventas covenants as a written agenda item for Grant Thornton's presentation to the committee. However, Koeppel removed the agenda item from Grant Thornton's presentation.

59. In planning for the year end 2010 audit, Grant Thornton scheduled site visits to the Ventas facilities after Koeppel and the Engagement Manager determined that those facilities were at higher risk for inaccurate occupancy reporting because of the Ventas lease covenant requirements and because ALC was barely passing the covenants. However, Grant Thornton's workpapers documenting its site visits to the Ventas facility do not reference any steps to validate the inclusion of employees in the covenant calculations. In fact, the Grant Thornton engagement team member who performed the site visit testing was unaware of the employee adjustment. Had Grant Thornton asked, employees who worked at the Ventas facilities would likely have told the Grant Thornton engagement team that only a handful of employees were staying at the facilities at any given time and that no rooms were being set aside or reserved at their facilities for employee use. Despite identifying the Ventas facilities as posing a higher risk, Koeppel failed to sign off on the results of the site visit procedures performed. Koeppel also failed to direct the site visit team to obtain support for ALC's use of employees in the covenant calculations, and failed to follow-up with the team to see if any such support had been obtained.

60. In the course of the year end 2010 audit, the Engagement Manager received a spreadsheet which showed the number of employees ALC included in the covenant calculations for each month during 2009 and 2010. One hour after receiving this information, the Engagement Manager sent an email to her subordinate, in which the Engagement Manager wrote:

> 2009 is quite odd-how do they suddenly have 70 employees staying here one month? Did we discuss this with them last year (i.e. how were they tracking these before)? Also, they go from 70, then down to 24, then back up. This seems very odd. . . . Not sure how accurate this is.

Nevertheless, the Engagement Manager failed to make any inquiries to ALC regarding her concerns or document her concerns in the workpapers.

61. Grant Thornton's workpapers for the 2010 year end audit included the occupancy recons, which showed that ALC included 61 employees in the covenant calculations for each day of the fourth quarter. The workpapers also noted that ALC would fail the occupancy covenants without the inclusion of employees. Both Koeppel and the Engagement Manager reviewed these workpapers.

62. For the 2010 year end audit, a Grant Thornton engagement team member suggested to Koeppel and the Engagement Manager that ALC's representation letter should contain a specific representation relating to ALC's use of employees in the covenant calculations. Koeppel responded, consistent with her view the prior quarter, by determining that the suggested representation was not necessary.

**c. The 2011 Engagement**

63. Robinson replaced Koeppel as the ALC engagement partner beginning with the first quarter 2011 review. With the exception of the third quarter 2011 review, Grant Thornton continued to staff the Engagement Manager as the manager on the ALC engagement. Prior to the 2011 year end audit, Grant Thornton approved the Engagement Manager's application for SEC designation, even though the Engagement Manager had still not completed the amount of public company engagement hours required under firm policy. In approving the application, Grant Thornton demanded that the NPPD continue to perform a detailed review in connection with the year end audit.

64. When Robinson assumed responsibility for the ALC engagement, the engagement team advised Robinson that ALC was including employees in its covenant calculations. After this was brought to Robinson's attention, he discussed the issue with Buono during an introductory lunch. Buono told Robinson that there was "an exchange of letters" that allowed ALC to use employees to meet the covenants. However, Robinson never obtained any such documentation.

65. During the first quarter 2011 ALC review, the Engagement Manager, as she had done with Robinson, brought the Ventas covenants to the attention of Grant Thornton's engagement quality reviewer (the "EQR"), who had joined the ALC engagement as the engagement quality reviewer on the 2010 audit. In the course of doing so, she sent an email informing the EQR that ALC was very close to missing the covenants.

66. In the course of the first quarter 2011 review, Grant Thornton learned that ALC had provided information showing that it failed one of the Ventas lease occupancy covenants. In reality, ALC had mistakenly included an insufficient number of employees to meet the covenant at issue. After Grant Thornton raised the failed covenant with ALC, ALC provided Grant Thornton with revised covenant calculations in which ALC added employees in order to pass all of the covenants.

67. In the following days, a Grant Thornton engagement team member emailed the Engagement Manager to apprise the Engagement Manager of her concerns that ALC had added employees after initially failing a covenant. The engagement team member also proposed that the Engagement Manager request from Buono a letter confirming Ventas's agreement to allow

employees to be included in the covenant calculations. When the engagement team member spoke with the Engagement Manager, the Engagement Manager shared her assessment that ALC's use of new employees to remedy a covenant failure was "odd." However, Grant Thornton did not request additional support from ALC. When a second junior engagement team member learned that Grant Thornton had not followed up with Buono on obtaining a letter concerning the employee adjustment, he wrote an email to the first engagement team member observing that: "I don't think we're ever going to get this mystery letter."

68. ALC's workpapers for the first quarter 2011 review included the occupancy recons, which showed that ALC included between 60 and 65 employees in the covenant calculations for each day of the quarter. The workpapers also noted that ALC would fail the occupancy covenants without the inclusion of employees. Both Robinson and the Engagement Manager reviewed these workpapers. In a separate section of the workpaper, Grant Thornton noted that ALC had failed the occupancy covenant for one of the facilities in the first draft of the covenant calculations but explained that Buono had "found" additional employees which allowed ALC to pass.

69. The SSM for the first quarter 2011 review again identified the Ventas covenants as a significant matter. The relevant paragraph was substantially similar to the paragraph in the third quarter 2010 SSM except that it omitted the reference to Buono's representation that Ventas was receiving occupancy recons. Robinson, the EQR, and the Engagement Manager each reviewed this SSM.

70. At Robinson's request, Grant Thornton sent ALC a proposed representation letter for the first quarter 2011 review which contained a specific representation relating to the inclusion of employees in the covenant calculations. However, when Buono requested that Grant Thornton remove this representation, Robinson and the Engagement Manager acquiesced.

71. In the course of its second quarter 2011 review, Grant Thornton learned that ALC had received a comment letter from the Commission's Division of Corporation Finance relating to ALC's 2010 Form 10-K, which requested, among other things, that ALC disclose its performance relative to the Ventas covenants if it remained at "risk of non-compliance." Grant Thornton reviewed ALC's proposed response to the comment letter, in which ALC wrote that it did "not believe that it has a reasonably likely degree of risk of breach of the [Ventas] covenants" and that it would add such a disclosure to its subsequent Commission filings. ALC in fact added such a disclosure to its Commission filings beginning with its second quarter 2011 Form 10-Q. Grant Thornton did not suggest any revisions to ALC's final response letter or to ALC's additional disclosure in its Commission filings.

72. ALC's workpapers for the second and third quarter 2011 reviews included the occupancy recons, which showed that ALC included between 73 and 88 employees in the covenant calculations for each day of the quarter. The workpapers again noted that ALC would fail the occupancy covenants without the inclusion of employees.

73. The SSM for the second and third quarter 2011 reviews contained identical paragraphs as the first quarter 2011 SSM with respect to the Ventas covenants. Robinson, the Engagement Manager, and the EQR reviewed both SSMs.

74. In preparation for the 2011 year end audit, Grant Thornton again recognized the risk associated with the financial covenants. The planning meeting agenda for the audit included an item identifying areas where "ALC management could perpetrate and conceal fraudulent financial reporting." The agenda identified "occupancy (affecting covenants and bonuses)" as one such area for potential fraud. Robinson, the EQR, and the Engagement Manager reviewed this agenda.

75. During the 2011 audit, Grant Thornton for the first time requested a copy of the quarterly covenant calculations that ALC sent to Ventas. Grant Thornton made this request after the Engagement Manager reviewed the fourth quarter 2011 occupancy recon and saw that 50 percent of the available units at one of the Ventas facilities and 25 percent of the available units at another facility were purportedly occupied by ALC employees.

76. In response to Grant Thornton's request, ALC provided copies of the quarterly materials it sent to Ventas. Those materials, like all of the earlier covenant information ALC had provided to Ventas, did not contain any information indicating that employees were being included in the covenant calculations or the number of such employees.

77. A Grant Thornton engagement team member emailed the materials to the Engagement Manager and wrote: "The excel document [sent to Ventas] is exactly what we receive [in the occupancy recons], except they exclude the tab where they add employees (*as we had kind of expected*)" (emphasis added). The Engagement Manager responded to the email by writing that "I just don't know how comfortable I am with this." the Engagement Manager wrote that she called Buono to seek an explanation, but left a voicemail when Buono did not answer. The engagement team member then forwarded the Engagement Manager's email to a junior team member, but not the Engagement Manager, writing: "I wish I could be on this call . . ." The junior engagement team member responded: "Holly s---."

78. Buono did not return the Engagement Manager's call. In the meantime, the engagement team continued to be concerned about the employee adjustment. The day after leaving the voicemail for Buono, the Engagement Manager emailed Robinson and noted that the Ventas covenant calculations were still an "open item" because: (1) ALC wasn't sending Ventas the employee occupancy information that Grant Thornton had been reviewing; and (2) she wanted to question Buono on why so many of the occupants at two Ventas facilities were ALC employees.

79. Eight days after the Engagement Manager left the voicemail, Buono still had not returned her call. The Engagement Manager then left another voicemail for Buono in which she said that she wanted to discuss the Ventas covenants because the numbers for the quarter looked "odd." Four days later, when Buono still had not returned her calls, the Engagement Manager emailed Robinson to ask whether they should speak with the Chairman of ALC's Audit Committee because Buono "still hasn't responded to my questions with my concerns about how they are 'meeting' these covenants."

80. In the meantime, both Robinson and the Engagement Manager again suggested adding a representation to ALC's representation letter that specifically addressed the Ventas covenants, and Grant Thornton included such a representation in the draft letter it sent to ALC.

81. Eleven days after the Engagement Manager's initial voicemail to Buono, the two finally spoke. On the call, the Engagement Manager failed to raise her concerns that ALC employees represented 50% of the occupancy of one Ventas facility and 25% of the occupancy of another facility. Rather, Buono requested that Grant Thornton remove the Ventas covenant representation contained in the draft representation letter Grant Thornton had sent to ALC.

82. In response, the Engagement Manager asked Buono to provide some evidence that Ventas knew that ALC was including employees in the covenant calculations. Buono then described to the Engagement Manager: (1) a conference call with Ventas in 2009 during which Buono claimed that Ventas was notified about the inclusion of employees in the covenant calculations; and (2) an email from Bebo to Ventas confirming such conversation. The conversation ended with the Engagement Manager requesting a copy of the email.

83. Shortly after the conversation, Buono sent the Engagement Manager via email a copy of the February 4 email, which contained no mention of the Ventas covenants. The Engagement Manager also provided a copy of the February 4 email to Robinson. One minute after receiving the February 4 email from Buono, the Engagement Manager responded to Buono that she would remove the Ventas covenant specific representation from the final representation letter. The Engagement Manager did not consult with Robinson before removing the representation. However, in a subsequent conversation with Robinson, the Engagement Manager described the sequence of events and Robinson indicated his agreement with her decisions.

84. Grant Thornton's 2011 audit workpapers included the occupancy recons, which showed that ALC included 92 employees in the covenant calculations for each day of the fourth quarter. The workpapers also contained a notation that the revenue associated with the employee occupants allowed ALC to satisfy the coverage ratio covenants. Other workpapers, which Robinson and the Engagement Manager reviewed, also contained the incorrect observation contained in prior workpapers that Ventas received quarterly information showing the number of employees ALC included in the covenant calculations.

85. As was the case for 2009 and 2010, Grant Thornton issued an audit report that included an unqualified opinion on ALC's 2011 financial statements.

### 4. The 2012 Engagement

86. During the reviews of ALC's interim financial statements for the first and second quarters of 2012, Robinson, the EQR, the Engagement Manager and the NPPD received additional information which indicated the impropriety of ALC's inclusion of employees in the covenant calculations. Grant Thornton did not withdraw its audit opinions on ALC's prior period financial statements.

87. In the course of its first quarter 2012 review, Grant Thornton learned that Ventas had issued notices of default to ALC as a result of ALC receiving license revocations at certain of the Ventas facilities. On April 24, 2012, the Engagement Manager emailed Robinson to express her concerns regarding ALC's efforts to resolve its disputes with Ventas, which included ALC offering Ventas $15 million to terminate the lease. The Engagement Manager wrote:

> Ventas may not realize the full extent to which occupancy has dropped. Although they are getting close to a deal on the properties now, what happens when Ventas finds out occupancy is actually much lower than expected as ALC has been filling with employees. This is going to happen when they enter the properties. I wonder if Ventas might ask for more then because they may see it as the properties having depreciated more.

88. On April 26, 2012, when the efforts to settle the license revocation issues collapsed, Ventas sued ALC in federal court. ALC and Ventas would ultimately settle that litigation, after Ventas learned that ALC was including employees in the covenant calculations, with ALC purchasing the Ventas facilities for $37 million more than the facilities' appraised value.

89. In May 2012, Robinson, the EQR, the Engagement Manager and the NPPD learned that a whistleblower had submitted a complaint to ALC's Audit Committee relating to the inclusion of employees in the covenant calculations and that ALC's Audit Committee had retained a prominent law firm to conduct an internal investigation of the allegations. While Grant Thornton was not provided with a copy of the whistleblower complaint until December 2012, ALC's law firm described the whistleblower's allegations to Robinson and the Engagement Manager during a meeting on May 14, 2012. In its workpapers, Grant Thornton noted that the whistleblower had alleged that the employees included in the covenant calculations were not performing any services at the Ventas facilities or even leaving ALC headquarters. The workpapers also noted the whistleblower's disclosure that the employee numbers were reverse engineered to meet the covenants. Robinson, the EQR, and the Engagement Manager prepared or reviewed these workpapers.

90. On May 11, 2012, Robinson received an email from the Chairman of ALC's Audit Committee attaching notices of default which ALC had received from Ventas. In one of those notices, Ventas asserted that ALC had committed fraud by including employees in the covenant calculations. In the cover email, ALC's Audit Committee chair indicated that ALC management was not authorized to speak with Grant Thornton about the matters being investigated by the law firm retained by ALC's Audit Committee.

91. In the course of Grant Thornton's second quarter 2012 review, the Engagement Manager prepared workpapers to explain the accounting for ALC's purchase of the Ventas facilities, which indicated that ALC had paid Ventas $37 million in excess of the appraised value of those facilities "for damages as a result of occupancy rates falling significantly below required covenant occupancy rates." Robinson, the EQR, the NPPD and other members of Grant Thornton's professional standards group reviewed these workpapers.

## F. GRANT THORNTON'S AUDIT AND REVIEW OF BROADWIND

### 1. Background on the Recording of Intangible Assets

92. GAAP typically does not permit the recognition of intangible assets, such as customer relationships, as independent assets on a company's balance sheet. An exception to this general rule is intangible assets purchased in connection with a business combination. In that

context, GAAP requires the consideration for an acquisition to be allocated across the tangible and intangible assets, with the remainder recorded as goodwill.

93. In connection with the Brad Foote acquisition in October 2007, Broadwind recorded amortizable intangible assets of $76 million and goodwill of $26 million. Nearly the entire $76 million intangible asset related to Brad Foote's contracts with its two most significant customers, Customer 1 and Customer 2, which were recorded at $62 million and $13 million, respectively. To establish the intangible asset value, management relied on a valuation conducted by an appraisal firm, Appraisal Firm 1. Appraisal Firm 1's valuation depended in substantial part on the forecasted net cash flows derived from the Customer 1 and 2 contracts over ten- and nine-year periods, respectively. Appraisal Firm 1 calculated those net cash flows from forecasts and estimated growth rates provided by senior managers at Broadwind. The net sales forecasts reflected management's anticipation of aggressive growth.

94. Once established, an amortizable intangible asset is subject to periodic impairment testing. According to Accounting Standards Codification ("ASC") 360, originally promulgated as Financial Accounting Standard ("FAS") 144, an intangible asset is impaired when the carrying amount of the asset exceeds its fair value. A company is required to make this determination "whenever events or changes in circumstance indicate that its carrying amount may not be recoverable." One such "triggering event" is "a current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (or asset group)." Other examples of such triggering events include "a significant adverse change in the extent or manner in which a long-lived asset (or asset group) is being used or in its physical condition" or "a significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (or asset group), including an adverse action or assessment by a regulator." Broadwind purported to follow the accounting principles established by FAS 144.

**2. The Decline of Broadwind's Customer Relationships**

95. Beginning in late 2008, Customers 1 and 2 significantly reduced actual and forecasted orders, causing substantial declines in Brad Foote's projected revenue associated with those relationships. Broadwind reacted to the downturn by planning or implementing numerous initiatives to rationalize the business, including decreasing headcount, returning machines to equipment suppliers, altering production schedules, and withholding investments in additional capacity.

96. Throughout the first quarter of 2009, the declines in Customer 1 and 2's revenues and forecasts worsened, falling more than 66% and 71% from the original forecast used to value the customer relationships. In response, Brad Foote took steps to restructure its workforce and operations, laying off more than 200 employees and senior staff through at least three workforce reductions, and reducing its material orders from suppliers. Brad Foote aggressively sought business from other non-wind customers to replace the significant declines and correct the underutilization of its capacity.

97. In early 2009, as its financial condition worsened, Broadwind received early indications of potential impairment while preparing its 2008 annual report. During its 2008 financial statement audit, Broadwind retained Appraisal Firm 1 to test its goodwill and intangible assets for potential impairment. In March 2009, Appraisal Firm 1 informed Broadwind that it had calculated a $15 million impairment charge associated with the Customer 1 contract. Appraisal Firm 1 subsequently modified its calculations, which resulted in no impairment. Although the Company ultimately did not disclose a charge in its 2008 Form 10-K, following consultation with Grant Thornton, Appraisal Firm 1's preliminary result placed Broadwind's management on further notice of the potential for impairment.

98. During the second quarter of 2009, the Customer 1 and 2 relationships deteriorated more precipitously. At a special board meeting convened on June 9, 2009, Brad Foote management reported that Brad Foote would produce no more than $85 million in sales for 2009, compared to $120 million in previously anticipated sales. Management also reported that 2009 revenue forecasts for Customer 1 had decreased to $30 million and that the 2009 revenue forecasts for Customer 2 had declined to $15 million. In connection with a "massive and sudden schedule" reduction imposed by Customer 1 and other developments, Broadwind and Brad Foote began developing a "life without Customer 1" business plan, and several members of management expressed the desire to exit the relationship.

99. For Brad Foote as a whole, second quarter 2009 revenue fell 31% against the second quarter of 2008 and 24% compared to the first quarter of 2009, and its gross margin turned negative. As in previous months, Brad Foote continued its efforts to redirect sales from Customers 1 and 2 to new customers and implemented additional workforce reductions.

100. In the third quarter of 2009, Brad Foote's actual and forecasted revenue continued to decline. Specifically, year-to-date revenues from Customer 1 and Customer 2 through September 30, 2009 declined 42% and 25%, respectively, compared to the same period ending September 30, 2008.

101. On July 29, 2009, Broadwind's CEO provided the Board a "rationalization update" that described the precipitous decline and the restructuring that management was taking to respond to weak performance. During the meeting, Brad Foote management presented a financial forecast for Brad Foote showing that the expectation for Brad Foote sales for 2009 had declined by $49 million, or 41% to a newly revised forecast of $71 million. Brad Foote management also projected net income of *negative* $16 million for the year. During a portion of the presentation discussing "risks to [the] income statement," Broadwind management identified "continued loss of volume" and "impairment at subsidiaries."

102. The declines in actual and forecasted results were not limited to 2009. Revenue forecasts for future years also declined. For instance, on July 30, 2009, Customer 1 submitted a 2010 forecast that was only 13% of the $125 million 2010 projection used to establish the acquisition value of the Customer 1 contract.

103. Around this same time, Brad Foote management informed the Board that Brad Foote would generate revenues of $30 million from Customer 2 in 2010, $41 million in 2011, and

$54 million in 2012. On average, those forecasts represented a 70% decline from the comparable period forecasts originally used to value the Customer 2 contract.

104. A board meeting was scheduled for October 1, 2009 to determine whether the ~~Board should sever its relationship with Customer 1. At that meeting, the Board decided not to~~ terminate Broadwind's relationship with Customer 1. However, Broadwind continued to budget for and anticipate impairment in several documents and communications through December 2009.

### 3. Broadwind's Misrepresentations and Omissions in Its Commission Filings

105. As a result of these developments, by the third quarter of 2009, the intangible assets associated with the Customer 1 and 2 relationships met the triggering event tests established by FAS 144, and these assets were impaired. Consequently, Broadwind materially overstated its intangible assets and understated a material impairment charge in its Form 10-Q for the third quarter of 2009, which was filed on November 2, 2009.

106. Given the declines in its business and other developments, Broadwind resolved in October 2009 to raise additional capital through a public offering of its stock. In anticipation of the offering that ultimately proceeded in January 2010, Broadwind filed a registration statement with the Commission. The registration statement was initially filed on October 30, 2009 and was amended various times between November 6, 2009 and January 14, 2010. The registration statement ultimately went effective on January 14, 2010. All versions of Broadwind's registration statement included the interim financial statements that had been included in the Forms 10-Q filed through the end of the third quarter, September 30, 2009, and expressly incorporated prior reports by reference.

107. As was the case with the third-quarter Form 10-Q, Broadwind's registration statement was incomplete and misleading. By incorporating third-quarter interim financial statements that did not report the impairment charge, Broadwind failed to disclose that its intangible assets already had been substantially impaired. Failing to disclose the impairment allowed Broadwind to proceed with an offering that was critical to its financial survival and to give the misleading impression that its business was stronger than actual and predicted results established.

108. Less than two weeks after the completion of the offering, on February 2, 2010, Appraisal Firm 2 informed Broadwind's management of its preliminary finding of impairment.

109. Approximately one month later, Broadwind disclosed the impairment in its 2009 Form 10-K and earnings release, filed on March 12, 2010. Broadwind disclosed a $58 million charge to intangible assets and full impairment of its goodwill related to Brad Foote in the amount of $24 million. Described by the Board as "significant," the charge reduced the value assigned to customer contracts by 94%. Of the $58 million intangible impairment charge, $56 million directly related to the declining value of the Customer 1 and 2 relationships. Largely as a result of the charge, Broadwind's operating loss for the year increased from $28 million to $110 million on reported revenues of $198 million.

110. Following the revelation of the charge, Broadwind's stock declined 21%, from a closing price of $5.68 on March 11, 2010 to a closing price of $4.47 on March 12, 2010, on increased volume. On the next trading day, March 15, 2010, the price fell another 8% from the March 11, 2010 price to $4.11, for a total decline of 29%. In contrast, the broader market, as ~~reflected by the Nasdaq Composite Index, was essentially unchanged for these two days. The~~ charge also was significant because it signaled serious weaknesses in Broadwind's long-term prospects, particularly with two of the industry's largest players.

111. Because Broadwind did not recognize impairment as a third-quarter event, its Form 10-K for 2009 misstated third and fourth-quarter results. In the Form 10-K, Broadwind inaccurately attributed the impairment charge to fourth-quarter events when the events that resulted in the impairment were present during the third quarter.

**4. Grant Thornton's Early Warnings of Potential Impairment**

112. In inspection reports issued beginning in 2007, PCAOB notified Grant Thornton of several impairment audit deficiencies in other engagements. Further, in its 2008 and 2009 inspection reports, PCAOB notified Grant Thornton of issues regarding the effectiveness of Grant Thornton's firmwide quality controls with respect to (1) professional skepticism, (2) engagement supervision, and (3) impairment procedures.

113. As Broadwind's auditor, Grant Thornton learned of the decline in sales and volume that began in late 2008, as well as the restructuring steps undertaken by Broadwind to address the declines, through its audit work. For instance, Grant Thornton reviewed Broadwind's board and committee materials in connection with each of its reviews and audits. Grant Thornton's work papers also noted various negative developments through its review of financial metrics and conversation with accounting personnel and others at Broadwind.

114. In addition, because it reviewed and analyzed Appraisal Firm 1's work during the 2008 annual audit in early 2009, Grant Thornton also received the early indications of potential impairment identified by Appraisal Firm 1. Although Broadwind ultimately did not disclose an impairment charge in its 2008 Form 10-K, the preliminary result placed Broadwind and Grant Thornton on notice of the potential for impairment.

115. During the quarterly review for the period ending March 31, 2009, Grant Thornton asked management to prepare a memorandum documenting its consideration of triggering events that could indicate impairment of the intangible assets associated with the Customer 1 and 2 relationships. Management's memorandum to Grant Thornton recited the standard for impairment, noted the recent downturns, but summarily concluded that no triggering events had occurred.

116. Grant Thornton also requested a similar assessment for the second quarter of 2009. Management's memorandum again noted key customers' intentions to scale back orders, but summarily concluded these declines simply represented a delay in the timing of revenues and associated cash flows. With respect to the second quarter 2009 assessment, the senior manager for the Grant Thornton engagement team wrote the following to Koeppel:

> The problem is that the ability to forecast has been suspect with this group and whether or not the sales are suspended or eliminated is the question . . . their position is suspended which is how they get to no impairment. I think this meets adequate documentation at an interim date and not sure we are going to get a better product. Please let me know if you disagree and whether or not we should have more expansive forecasting to illustrate the expected revenues from these customers that have pushed out.

117. Despite these concerns, Koeppel failed to direct the engagement team to obtain more expansive forecasting from Broadwind, or to perform any additional procedures, during the second-quarter review. The Grant Thornton review file similarly included no documentation of any additional forecasting by Broadwind or additional procedures performed.

### 5. Grant Thornton Learns of Broadwind's Expectation of Impairment

118. In August 2009, after the continued deterioration of the Customer 1 and 2 customer relationships, Broadwind management shared with Grant Thornton its expectation that its intangible assets would be substantially impaired. Specifically, Grant Thornton received internal budgeted balance sheets and income statements for 2010 and other documents reflecting management's assumption that the entire Customer 1 contract intangible asset would be impaired by December 31, 2009. Several of these documents specifically identified an expected impairment charge of $48 million to be recorded in the fourth quarter.

119. After being informed on September 9, 2009 of management's expectation, Koeppel wrote to the senior manager: "Guess they see the writing on the wall for [Brad Foote]—seems like we need a triggering event?!?!?" One day later, the senior manager summarized for Koeppel a discussion with Broadwind's Chief Accounting Officer ("CAO") and Controller:

> The impairment has not been booked or determined, but they believe a Customer 1 triggering event is a week or two away and is based on a customer retention decision at the board level . . . [the CAO] feels they are slanting the board materials to keep Customer 1, but are not incorporating the true costs of the customer relationship which would potentially paint a different light.

120. Grant Thornton incorporated management's expectation in its planning for the third-quarter review and year-end audit of Broadwind's 2009 financial statements. On September 29, 2009, Broadwind and Grant Thornton met to plan the upcoming annual audit. Agenda and notes drafted by Grant Thornton in preparation for the meeting reflect "expected impairment," "loss of Customer 1 . . . FAS 144 writeoff," and the need "to get started as soon as possible." Relatedly, a client meeting agenda listed "impairment analysis" as a topic of discussion. Attachments to the agenda included other references to impairment and an estimated $48 million charge. A few days after the audit planning meeting, on October 4, 2009, Grant Thornton forwarded Broadwind's Controller guidance on impairment disclosures "as a follow up to [their] discussion regarding potential impairment."

**6. Grant Thornton's Failed Review of Broadwind's Third-Quarter Impairment Assessment**

121. Broadwind's third quarter ended on September 30, 2009. As discussed above, in ~~early October 2009, Broadwind decided to raise additional capital through a follow-on offering of~~ its stock, referred to as a "re-IPO," and began to prepare a registration statement. The Grant Thornton engagement team was aware that Broadwind was embarking upon an offering and understood that the offering was critical to Broadwind's financial survival. Grant Thornton also understood that Broadwind's CEO planned to participate in the offering by selling shares that he personally owned. Broadwind originally planned to complete the offering in late November 2009.

122. Grant Thornton's quarterly review of Broadwind's third-quarter interim financial statements began on October 21, 2009. On or about October 27, 2009, immediately before a planned filing of a registration statement, Grant Thornton learned that Broadwind's management had decided not to file the registration statement due to the withdrawal of the lead underwriter. After being informed by Broadwind's CFO that there were "underwriting issues at the last minute," Koeppel conveyed her understanding to the senior manager and manager that "impairment may be an issue/concern—they want to highlight it may occur—[the CAO's] and my concern is it starts to look like you should have already recorded it then—details, details!"

123. In connection with the third-quarter review, on or about October 29, 2009, despite prior communications of an expected impairment, Broadwind management once again prepared an impairment assessment for Grant Thornton that concluded that no triggering event had occurred. In the assessment, Broadwind incorporated a comparative table of year-to-date revenues by customer that reflected substantial revenue declines. Management summarily characterized these declines as temporary and asserted that long-term volumes had not been materially changed. However, management offered no specific evidence to support its view that orders would return to the volumes forecasted in 2007, and other facts contradicted its assertion. Based on this unsupported and incorrect conclusion, Broadwind failed to disclose a significant impairment charge in its Form 10-Q filed on November 2, 2009, opting instead for a generalized risk disclosure of the possibility of such a charge. Management's assessment was incorporated into a Grant Thornton working paper that was reviewed and approved by Koeppel and others on the engagement team.

124. Notwithstanding the awareness of a significant likelihood that the Customer 1 and 2 contracts were impaired, and despite lingering uncertainty about management's forecasting ability, Koeppel and others on the engagement team accepted management's unsupported assertion that the reduced orders only represented a temporary deferral of sales that would be recovered over the life of the supply agreement. Grant Thornton noted in its workpapers, which Koeppel reviewed:

> GT notes that although volumes are below those projected by mgmt during the 2008 integrated audit, management does not believe that this is a triggering event due to the following. (i) BFGW continues to have long-term contracts with [Customer 1 and 2]. For example, the Customer 1 contract contains automatic renewals, termination provisions, etc. Current discussions with Customer 1 indicate increased future activity. (ii) These are

long-term relationships with an estimated useful life of 9 [Customer 2] and 10 [Customer 1] years. Thus, it is reasonable to assume that short-term reductions in volume will be made up over the longer term. Management does not believe, and GT concurs, that a short-term decrease from budgeted activity qualifies as a triggering event and such analysis does not seem to be supported by FAS 144.

125. Even though multiple facts known to Koeppel and the engagement team did not align with management's conclusion, and Grant Thornton knew that Broadwind was pursuing an offering, Grant Thornton did not perform any procedures to determine whether the order reductions were other than temporary. On the contrary, the review documentation noted that Grant Thornton simply "assume[d]" that these reductions were temporary. Among other things, Grant Thornton did not ask Broadwind to provide detailed information about Customer 1 and 2 volume expectations beyond 2009, which was available to management at the time. Grant Thornton's files do not include any documentation indicating how Koeppel or the engagement team determined the reasonableness and consistency of Broadwind's response in light of the results of other review procedures and their knowledge of the business.

126. In fact, Broadwind's response conflicted with longer-term forecasts presented to the Board as early as July 2009, which were available to Grant Thornton. Koeppel's experience with Broadwind since 2007 provided her with an understanding of Brad Foote's operations to recognize that Brad Foote required longer-term forecasts from Customer 1 and 2 to manage its material requirements and production schedule. Consequently, she should have known that 2010 volume forecasts were available at the time of the third-quarter triggering event assessment.

127. Further, during Grant Thornton's review of Broadwind's third-quarter impairment assessment memorandum, Grant Thornton's professional standards partner (the "PSP") assigned to the Broadwind engagement provided comments to Koeppel and the manager. The PSP had been assigned by Grant Thornton to monitor the Broadwind engagement as a result of Grant Thornton's designation of the engagement as high risk. In a communication to the engagement team about Broadwind's impairment assessment, the PSP wrote the following: "Are the revenues consistent with the projections used for their last impairment analysis? If they are significantly declined than that, then you would have a trigger you may need to revisit. They don't address this here. Also need GT conclusion & view on impairment in the files." Although the team's own third-quarter revenue analytics working papers demonstrated that the revenues were not consistent with the projections used for Broadwind's last impairment analysis, the engagement team did not revisit the triggers for an impairment analysis. The manager responded to the PSP simply that management viewed the contracts as long term, such that a short-term decrease from budget would not qualify as a triggering event.

### 7. Grant Thornton Defers to Broadwind in Its Comfort Letter

128. Broadwind's third-quarter 2009 interim financial statements were incorporated into its registration statement for the public offering in January 2010. In connection with the offering, Grant Thornton was retained to provide a comfort letter to investment bankers and reviewed draft registration statements and impairment disclosures. As Grant Thornton performed its procedures,

Koeppel and the engagement team learned that the Commission's Division of Corporation Finance had questioned Broadwind's impairment disclosures. As part of its review of Broadwind's registration statement, the Division of Corporation Finance issued Broadwind a comment letter in late November 2009. In response to comments questioning the Company's impairment disclosures, Broadwind added more detail to its description of its significant accounting policies in its MD&A and the notes to consolidated interim financial statements. However, the additional language simply provided more detail about the testing *process* and did not alter the substance of Broadwind's disclosures regarding impairment or the risk of impairment.

129. Following this expanded process disclosure, Koeppel and the senior manager defended the quality of Broadwind's disclosures surrounding impairment in email exchanges with the PSP. The PSP voiced serious reservations to the engagement team about the impairment disclosures and emphasized the company's obligation to provide an early warning to investors if it believed an impairment charge was reasonably possible. The PSP specifically cautioned Koeppel that "[w]e can't just turn a blind eye if we believe there is a good possibility they will have impairment." Koeppel and the senior manager addressed the PSP's concerns by obtaining a representation from management that impairment testing was in process but had not yet been completed. Grant Thornton's comfort letter expressly cautioned that it had not performed any procedures surrounding impairment of intangible assets with respect to the period from October to November 2009, deferring instead to its "inquiry of management."

### 8. Grant Thornton Negligently Audits Management's Allocation of Impairment Charge to the Fourth Quarter

130. In the course of its year end audit of Broadwind, Grant Thornton's workpapers failed to differentiate the fourth-quarter declines from comparable declines that occurred in prior periods. At the urging of the PSP just days prior to audit signoff, the engagement team considered whether the impairment charge should be recorded in the fourth quarter of 2009 or some earlier period. The resulting audit file memorandum, which Koeppel reviewed, relied on selected sales metrics to demonstrate a purported deterioration in the fourth quarter of 2009. In the memorandum, Grant Thornton reasoned that: (1) the fourth quarter 2009 revenue decline from fourth quarter 2008 (65%) and from third quarter 2009 (32%) was significant; and (2) prior to the fourth quarter, actual and forecasted revenue amounts related to the reporting unit were consistent with previous expectations.

131. Grant Thornton's observation that, prior to the fourth quarter, actual revenues were consistent with the prior year's forecasted revenues was incorrect and was contradicted by the engagement team's own revenue analytics documentation in each of the first three quarters of 2009. The team's third-quarter review impairment workpapers also acknowledged this underperformance by stating "that, although volumes are below those projected by [management] during the 2008 integrated audit, management does not believe that this is a triggering event." In fact, Brad Foote's actual quarterly revenues in 2009 failed to meet the forecasted revenues used in the fiscal year 2008 impairment analysis by significant margins. Moreover, Grant Thornton's reasoning applied with equal force to *prior* quarters in 2009, and these declines were documented by Grant Thornton each quarter in its revenue analytics working papers. In the second and third quarters, Brad Foote realized comparable declines in revenue. Second quarter 2009 revenue fell

31% against second quarter 2008 and 24% compared to first quarter 2009. Third quarter 2009 revenue fell 49% compared to third quarter 2008 and 19% compared to second quarter 2009.

132. The engagement team's memorandum on this issue failed to discuss whether or ~~how it considered the significant sales declines that had occurred in the third quarter in concluding~~ the company was correct in recording the impairment charge as a fourth-quarter event. Further, the team's inclusion of the inaccurate statement that actual revenues were consistent with prior-year projections reinforced the company's incorrect allocation of the impairment charge to the fourth quarter. Koeppel and Grant Thornton sought only evidence to corroborate management's conclusion while disregarding evidence from their own prior work that contradicted management's conclusion.

133. Around the same time that the PSP had asked the engagement team to evaluate the timing of the impairment charge, Koeppel provided Broadwind's CFO with comments on Broadwind's draft earnings release to be issued in connection with the filing of Broadwind's 2009 Form 10-K. The CFO's draft had attributed the impairment charge to "reduced wind gearing purchases under key customer contracts *beginning in late 2008*." (emphasis added). Koeppel urged the CFO to reevaluate the language in the release. Koeppel wrote: "We view the following reference to 2008 as problematic as it may suggest that you should have taken the impairment charge earlier . . . Suggest that you expand the sentence to focus on Q4 events which drove this assessment." Koeppel proposed these revisions to the press release *prior* to the engagement team's drafting of the memorandum purporting to document its consideration of the charge's timing.

### 9. Grant Thornton's Failure to Detect Broadwind's Overstatement of Revenue

#### a. Grant Thornton Identifies Revenue Recognition Risks

134. In the course of the 2009 year end audit, Koeppel and Grant Thornton identified the risk of material misstatement due to fraud in the area of revenue recognition at Broadwind's most significant subsidiary, Brad Foote, as a specific risk. Audit planning documentation identified the risk that "sales include fraudulent transactions" as "high" and "reasonably possible." Planning documentation further noted "possible incentive to play with earnings especially at the BFGW level (there are monthly sales targets included in their loan covenants)." More generally, Grant Thornton had identified the Broadwind engagement as a high-risk audit. This conclusion was influenced in part by Broadwind's prior disclosures of material weaknesses in controls over revenue recognition and other controls in earlier periods.

#### b. Overstatement of Revenue by Broadwind

135. This risk in fact materialized. The deterioration in customer relationships that produced the impairment charge also compromised Brad Foote's ability to meet monthly debt covenants associated with its primary credit facility. To avoid default and other negative consequences, Brad Foote personnel accelerated revenue to meet its covenants until Broadwind could raise funds to retire the credit facility through the offering in January 2010. Broadwind failed to disclose this practice and its effect on future revenue in the registration statement used in

the offering. In addition, as a result of the transactions, Broadwind reported $4 million of improperly recognized revenue for the third and fourth quarters of 2009, including certain bill-and-hold transactions entered with Customer 2. This revenue was material to Broadwind's financial results.

136. The Customer 2 bill-and-hold transactions had their genesis in a broader "pull-ahead agreement" between Customer 2 and Brad Foote. In response to forecast reductions in early 2009, Brad Foote personnel approached Customer 2 about pulling $6 million of orders, consisting of 150 sets of gear boxes, from 2010 into 2009 "to ensure [Brad Foote's] future compliance with debt covenants" and its ability to continue supplying gearboxes to Customer 2. Brad Foote's proposal was not requested by Customer 2 or tied to any commercial need on the part of Customer 2 beyond the survival of a critical supplier. The 150 sets were to be pulled from requirements that were scheduled to ship in 2010 and would not be consumed until the first half of 2010. Because Customer 2 had no need for the sets and would carry the 150 sets as excess inventory, Brad Foote proposed "to cover Customer 2's carrying and storage costs through deflation in 2010." In addition, because the long-term agreement with Customer 2 provided for an annual reduction in prices paid by Customer 2, Brad Foote agreed to accept 2010 prices for the parts. Brad Foote committed that it would not ship the products to Customer 2 if it were able to identify new business from other customers. After initially refusing the request, Customer 2 agreed to provide $3 million of support. Customer 2 scheduled the 75 sets to be delivered from late August 2009 through November 2009. Brad Foote's delivery of these sets caused significant disruption at Customer 2, given its lack of need for the parts until 2010. Brad Foote paid Customer 2 the carrying cost and the price reduction through a 1.5% discount that was spread over shipments that occurred in 2010.

137. As a result of the pull-ahead agreement, by October 2009, Customer 2 exceeded its ability to store the excess inventory. Consequently, Customer 2 approached Brad Foote about storing the remaining gear sets through a bill-and-hold arrangement. On October 31, 2009, Brad Foote agreed and entered into a bill-and-hold arrangement with respect to 30 gear sets totaling $1,247,160. The gears were not shipped to Customer 2, but instead were supposed to be segregated and maintained onsite at Brad Foote. Customer 2 required Brad Foote to segregate the product and provide evidence of completion and periodically inspect the product on site. Notwithstanding these efforts, Brad Foote failed to segregate the product consistently. The transaction failed to meet the criteria to recognize revenue under a bill-and-hold arrangement. *See In the Matter of Stewart Parness*, Accounting and Auditing Enforcement Rel. No. 108 (Aug. 5, 1986), Staff Accounting Bulletin 104, *Revenue Recognition.*

138. On November 30, 2009, Brad Foote placed 30 sets into a bill-and-hold arrangement similar to the one entered with Customer 2 in October 2009. Fifteen of these 30 sets completed the pull-ahead arrangement with Customer 2, and Brad Foote documented Customer 2's request through the same email authorizing delivery in October 2009. The other half corresponded to an additional 15 sets not formally ordered by Customer 2 until December 2009. In total, Brad Foote recognized $1,194,471 of revenue associated with these 30 sets. As with the October 2009 shipment, Broadwind failed to produce evidence of Customer 2's substantial business purpose for the arrangement and failed to comply with other requirements of a proper bill-and-hold arrangement.

### c. Grant Thornton's Audit of the Bill-and-Hold Arrangement

139. Grant Thornton never learned the details of the bill-and-hold arrangement. During the 2009 year end audit, Grant Thornton identified the October 2009 transaction as a transaction for further review. However, the engagement team's testing of this transaction was limited to obtaining a summary of its terms from management. The summary failed to identify several aspects of the transaction critical to its proper accounting, including, among other things, the price discount and the inventory carrying cost. For example, interviews with Brad Foote personnel, review of documents associated with the transaction, or confirming the terms directly with Customer 2 could have revealed that the bill-and-hold arrangement was the product of a large-scale pull-ahead agreement and had no independent business purpose.

140. More broadly, prior to the conclusion of the audit, management identified multiple problematic transactions at Brad Foote designed to meet monthly revenue covenants during a pending offering. These transactions included improperly recorded bill-and-hold transactions that should have raised additional questions about the October 2009 transaction with Customer 2. The engagement team did not document how it altered the nature, timing, or extent of its audit procedures in a manner that addressed this risk.

141. Koeppel participated in the audit planning process and fraud brainstorming discussion, signed off on the audit working papers in which the identified risks were documented, and signed off on working papers concluding that the Customer 2 bill-and-hold transaction met applicable revenue recognition criteria.

### d. Retention of Supporting Documentation in the Audit File

142. As discussed above, Broadwind identified and corrected certain transactions in which it had improperly recognized revenue through an internal review conducted by management from late 2009 to early 2010. A report of the internal review provided to Grant Thornton and referenced in its working papers identified multiple instances of improper revenue recognition, which included backdated letters, side agreements, unauthorized bill-and-hold transactions, and a directive not to record a credit memo. These transactions contributed to an overstatement of revenue that enabled Brad Foote to barely meet its debt covenants in the months leading to a critical stock offering. However, the engagement team did not retain a copy of the report or supporting documentation for the questionable transactions in the audit file.

## G. VIOLATIONS

RULE 102(e) AND SECTION 4C OF THE EXCHANGE ACT

143. Grant Thornton's 2009, 2010, and 2011 audits of ALC, and its 2009 third quarter review and year end audit of Broadwind were deficient and not performed in accordance with PCAOB standards.[8] Section 4C(b) and Rule 102(e)(1)(iv) define improper professional conduct

[8] References to auditing standards in this Order are to PCAOB standards in effect at the time the audit work was performed. For example, the PCAOB risk assessment standards (AS 8-15)

with respect to persons licensed to practice as accountants. Pursuant to these provisions, "improper professional conduct" includes two types of negligent conduct: (1) a single instance of highly unreasonable conduct that results in a violation of professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted; or (2) repeated instances of unreasonable conduct, each resulting in violations of professional standards, that indicate a lack of competence.

144. As set forth above, Grant Thornton knew, or should have known, that the Ventas financial covenant calculations were an area in which heightened scrutiny was warranted in connection with the 2009, 2010 and 2011 audits of ALC. Moreover, Grant Thornton knew or should have known facts that called into question ALC's claims that it was meeting the Ventas lease covenants by virtue of an agreement with Ventas to include employees and other non-residents in the covenant calculations. Throughout the 2009, 2010, and 2011 audits and reviews, Grant Thornton was aware of repeated red flags surrounding ALC's practice of meeting the covenants by treating employees and other non-residents as occupants of the Ventas facilities. In light of these red flags, Grant Thornton failed to take reasonable steps to verify that an agreement with Ventas existed or that the employees ALC claimed to be occupants of the facilities were in fact staying there. Had Grant Thornton taken such measures, it could have exposed and put an end to ALC's fraud. Instead, Grant Thornton issued audit reports in 2009, 2010, and 2011containing unqualified opinions that were filed with ALC's financial statements in the Form 10-Ks. In those reports, Grant Thornton inaccurately stated that the audit had been conducted in accordance with PCAOB standards and that ALC's financial statements presented fairly, in all material respects, the company's position and results in conformity with accounting principles generally accepted in the United States of America.

145. Further, in the course of its 2009 third quarter review of Broadwind, Grant Thornton knew, or should have known, that Broadwind's financial statements omitted a $58 million impairment charge associated with its deteriorated customer relationships for Brad Foote's two most important customers. Additionally, in the course of its 2009 year end audit of Broadwind, Grant Thornton knew or should have known that Broadwind's impairment charge was not a fourth-quarter event and that Broadwind's third and fourth quarter financial statements materially overstated revenue.

*Failure to Properly Plan the Audit (AU §§ 311 and 312, AS 8, AS 9)*

146. PCAOB standards require an auditor to consider the nature, extent and timing of work to be performed in planning the audit and prepare a written audit program which sets forth in reasonable detail the audit procedures necessary to accomplish the audit objectives. (AU § 311.05). Auditors must also consider audit risk and materiality in planning the audit and designing audit procedures. (AU § 312.12). Auditors additionally must plan the audit so that audit risk will be limited to a low level appropriate for expressing an opinion on the financial statements. (AU §

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became effective for audits of fiscal years beginning on or after December 15, 2010 (*i.e.*, the 2011 audit of ALC) and superseded AU *§§* 311, 312, 326, among others.

312.13). Auditors are also required to consider significant risk of material misstatement of the financial statements in: (1) determining the nature, timing or extent of procedures; (2) assigning staff; and (3) requiring appropriate levels of supervision. (AU § 312.17). In planning an audit, auditors must also design procedures to obtain reasonable assurance of detecting misstatements that the auditor believes could be material. (AU § 312.25, AS 8.3).

147. PCAOB standards also require auditors to properly plan their audits and develop and document an audit plan that includes a description of, among other things: (1) the planned nature, timing and extent of substantive procedures; and (2) other planned audit procedures required to be performed so that the engagement complies with PCAOB standards. (AS 9.4, AS 9.10).

148. As a result of Grant Thornton's conduct described above, Grant Thornton failed to properly plan its 2009, 2010 and 2011 audits of ALC.

*Failure to exercise due professional care and professional skepticism (AU §§ 230, 316, 722, and AS 13)*

149. PCAOB standards require auditors to exercise due professional care in the planning and performance of the audit and the preparation of the report. (AU § 230.01). Auditors must maintain an attitude of professional skepticism, which includes "a questioning mind and a critical assessment of audit evidence." (AU § 230.07, AS 13.7). In addition, the auditor should "consider the competency and sufficiency of the evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the audit process." (AU § 230.08). In exercising professional skepticism, an auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest. (AU §§ 230.09 and 316.13). Further, auditors should: (1) perform an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred; and (2) conduct the engagement with a mindset that recognizes that a material misstatement due to fraud could be present, regardless of past experience with the entity and the auditors' belief about management's honesty and integrity. (AU § 316.13). Auditors should also exercise due professional care and professional skepticism in the course of reviews of interim financial information. (AU § 722.01).

150. As a result of Grant Thornton's conduct described above, Grant Thornton failed to exercise due professional care and professional skepticism in its 2009, 2010 and 2011 audits of ALC and its 2009 third quarter review and year end audit of Broadwind.

*Failure to obtain sufficient evidence (AU §§ 326 and 333, AS 13, 14 and 15)*

151. PCAOB standards required auditors to obtain sufficient competent evidential matter (for the 2009 Broadwind audit and the 2009 and 2010 ALC audits) and sufficient appropriate audit evidence (for the 2011 ALC audit) to afford a reasonable basis for an opinion with respect to the financial statements under audit. (AU § 326.22, AS 15.4). Auditors must be thorough in their search for evidential matter and unbiased in its evaluation and consider relevant evidential matter

regardless of whether it corroborates or contradicts assertions in the financial statements. (AU § 326.25, AS 15.2 and 15.29).

152. PCAOB standards also provide that management representations "are not a substitute for the application of th[e] auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit," that "the auditor obtains written representations from management to complement other auditing procedures," and that "[i]n exercising professional skepticism, the auditor should not be satisfied with less than persuasive evidence because of a belief that management is honest." (AU §§ 333.02, 333.03, 230.09). Auditors must also: (1) obtain corroboration for management's explanation regarding significant unusual or unexpected transactions, events, amounts or relationships; and (2) perform procedures if management's responses to the auditor's inquiries appear to be implausible, inconsistent with other audit evidence, imprecise or not at a sufficient level of detail to be useful. (AS 14.8).

153. Auditors should also design and perform audit procedures in a manner that addresses the assessed risks of material misstatement for each relevant assertion of each significant account and disclosure. (AS 13.8). In designing such audit procedures, auditors should obtain more persuasive audit evidence the higher the auditor's assessment of risk. (AS 13.9). Auditors should also perform substantive procedures, including tests of details, for significant risks, and the evidence auditors obtain from substantive procedures should increase as the assessed risk of material misstatement increases. (AS 13.11, AS 13.37).

154. As a result of Grant Thornton's conduct described above, Grant Thornton failed to obtain sufficient evidence supporting assertions in ALC's 2009, 2010 and 2011 Form 10-K financial statements that ALC was in compliance with the Ventas lease covenants. In the course of its 2009 year end audit of Broadwind, Grant Thornton also failed to obtain sufficient evidence supporting the conclusion that the impairment was a fourth-quarter event and that the Customer 2 bill and hold transaction met the applicable revenue recognition criteria.

*Failure to Properly Supervise the Engagement Team (AU § 311 and AS 10)*

155. PCAOB standards note that audit "assistants," including firm personnel other than the auditor with final responsibility for the audit, are to be "properly supervised." (AU §§ 311.01 and 311.02). Those standards further require that assistants be informed of their responsibilities and the objectives of procedures assigned to them, and that the work of assistants be reviewed to determine whether it was adequately performed. (AU §§ 311.12, 311.13, and AS 10.5).

156. As a result of Grant Thornton's conduct described above, Grant Thornton failed to properly supervise the engagement team on its 2009, 2010 and 2011 ALC engagements.

*Failure to Make Additional Inquires or Perform Additional Procedures in the Course of Reviewing Interim Financial Information (AU § 722)*

157. PCAOB standards provide:

> If, in performing a review of interim financial information, the accountant becomes aware of information that leads him or her to believe that the interim financial information may not be in conformity with generally accepted accounting principles in all material respects, the accountant should make additional inquiries or perform other procedures that the accountant considers appropriate to provide a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information.

(AU § 722.22).

158. As a result of Grant Thornton's conduct described above, Grant Thornton violated AU § 722.22 when it failed to make appropriate additional inquires or perform other procedures in the course of its third quarter 2009 review of Broadwind's impairment assessment.

*Failure to Prepare Required Documentation (AS 3)*

159. PCAOB standards mandate that an auditor's documentation contain sufficient information to enable an experienced auditor, having no previous connection to the engagement to: (1) understand the nature, timing, extent and results of the procedures performed, evidence obtained and conclusions reached; and (2) determine who performed the work and the date such work was completed as well as the person who reviewed the work and the date of such review. (AS 3.1, 3.6). Auditors are also required to document significant findings and issues, including the actions taken to address them and the basis for the conclusions reached. (AS 3.12).

160. As a result of Grant Thornton's conduct described above, Grant Thornton failed to obtain required audit documentation on its 2009, 2010 and 2011 audits of ALC and its 2009 year end audit of Broadwind.

*Failure to Perform Adequate Personnel Management (QC 20 and 40)*

161. PCAOB Quality Control Standards require an auditing firm to establish policies and procedures which provide the firm with reasonable assurance that (a) those hired possess the appropriate characteristics to enable them to perform competently and (b) work is assigned to personnel having the degree of technical training and proficiency required in the circumstances. (QC 20.13 and QC 40.2).

162. As a result of Grant Thornton's conduct described above, Grant Thornton violated QC 20.13 and QC 40.2 in staffing the ALC engagements.

*Finding*

163. As a result of the conduct described above, the Commission finds that Grant Thornton engaged in improper professional conduct within the meaning of Sections 4C(a)(2) and 4C(b)(2) of the Exchange Act and Rules 102(e)(1)(ii) and 102(e)(1)(iv)(B) of the Commission's Rules of Practice. Grant Thornton's conduct in the 2009, 2010, and 2011 audits of ALC, and its

2009 third quarter review and year end audit of Broadwind involved repeated instances of unreasonable conduct, each resulting in violations of PCAOB standards and indicating a lack of competence, and also satisfies the standard of highly unreasonable conduct resulting in violations of PCAOB standards in circumstances in which heightened scrutiny was warranted.

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GRANT THORNTON WAS A CAUSE OF VIOLATIONS OF SECTION 13(a) OF THE EXCHANGE ACT AND RULES 13a-1 AND 13a-13 THEREUNDER

164. Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require that every issuer of a security registered pursuant to Section 12 of the Exchange Act file with the Commission annual and quarterly reports (i.e., Forms 10-K and 10-Q) as the Commission may require. The obligation to file such reports embodies the requirement that they be true and correct.

165. ALC's annual reports on Form 10-K for fiscal years 2009, 2010 and 2011 included audit reports from Grant Thornton that stated its audits of ALC's financial statements were conducted "in accordance with the standards of the Public Company Accounting Oversight Board" and that ALC's financial statements presented fairly, in all material respects, the company's position and results. Broadwind's 2009 Form 10-K contained a similar representation by Grant Thornton. These statements were materially misleading. As a result of Grant Thornton's above-described conduct, Grant Thornton's 2009, 2010 and 2011 audits of ALC and 2009 audit of Broadwind were not conducted in accordance with PCAOB standards and the financial statements included in ALC's 2009, 2010 and 2011 Forms 10-K were materially misstated because, among other things, they incorrectly represented that ALC was in compliance with the Ventas lease financial covenants. As for Broadwind, its Form 10-Q for the third quarter of 2009 materially overstated its intangible assets and understated a material impairment charge, and its 2009 10-K misstated revenue and incorrectly described its $58 million impairment charge as a fourth quarter event. At a minimum, Grant Thornton knew or should have known that its unreasonable conduct would contribute to ALC's filing of inaccurate 2009, 2010 and 2011 Forms 10-K and Broadwind's filing of an inaccurate third quarter 2009 Form 10-Q and 2009 Form 10-K.

166. As a result of the conduct described above, the Commission finds that Grant Thornton was a cause of ALC's violations of Section 13(a) of the Exchange Act and Rule 13a-1 thereunder and Broadwind's violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

## H. UNDERTAKINGS

167. Grant Thornton's Review. Within 120 days after the entry of this Order, Grant Thornton shall perform and complete a review and evaluation ("Grant Thornton's Review") of the sufficiency and adequacy of Grant Thornton's quality controls, including its policies and procedures for audits and interim reviews regarding the following (hereinafter referred to as "Grant Thornton's Policies"):

a) the exercise of due professional care and professional skepticism (as set forth in AU 230);

b) auditing estimates (as set forth in AU 342 and AS 14), including, but not limited to:

   (i) considering the relevance, reliability, and sufficiency of the factors and data used in forming the assumptions underlying estimates; and

   (ii) evaluating the results of procedures performed, including whether the evidence obtained supports or contradicts the estimates included in the financial statements;

c) appropriately responding to the risk of material misstatement related to potential impairment, including through the performance of procedures to resolve inconsistencies in the evidence obtained (as set forth in AS 13 and AS 15);

d) assessing the risk of fraud, including the risk of fraud involving management override of controls, and appropriately responding to identified fraud risks (as set forth in AU 316, AS 12, AS 13 and AS 14);

e) evaluation of evidence obtained concerning matters that are the subject of written representations from management in order to consider the reliability of the representation made and whether reliance on management's representations is appropriate and justified (as set forth in AU 333);

f) obtaining sufficient appropriate audit evidence (as set forth in AS 15);

g) effective supervision by engagement partners and managers, including review of work performed by the engagement team (as set forth in AS 10);

h) consultations with local, regional or national office technical oversight professionals;

i) appropriate resolution of concerns or disagreements in views among an engagement team regarding conclusions (i.e., accounting and auditing) reached in connection with an audit (as set forth in AS 10);

j) audit documentation, including risk assessment procedures and responses, significant findings and resulting actions, work paper sign-off, archiving, and dating (as set forth in AS 3);

k) compliance with the requirements for engagement quality reviewers (as set forth in AS 7);

l) obtaining reasonable assurance (as set forth in QC 20 and QC 40) that

i) the engagement partner and other individuals assisting the engagement partner in supervising the engagement possess the competencies that are necessary and appropriate in the individual circumstances, and

ii) work is assigned to personnel having the degree of technical training and proficiency required in the circumstances;

m) the identification, monitoring and remediation of audit partners with negative quality indicators, including the development and implementation of corrective actions (as set forth in QC 30); and

n) reporting, evaluation, and compensation of professional practice personnel (as set forth in QC 20 and QC 40).

Grant Thornton's Review shall assess the forgoing areas to determine whether Grant Thornton's Policies are adequate and sufficient to provide reasonable assurance of compliance with all relevant Commission regulations and PCAOB standards and rules.

168. Grant Thornton Report. Within 60 days of completing the Grant Thornton Review, Grant Thornton shall deliver to the Commission staff a detailed written report ("Grant Thornton Report") summarizing its review and changes to Grant Thornton's Policies, if any, to provide reasonable assurance of compliance with all relevant Commission regulations and PCAOB standards and rules. The Grant Thornton Report 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 Grant Thornton agrees to provide such evidence.

169. Independent Consultant's Review. Grant Thornton has undertaken to retain, within 180 days after the entry of this Order, an independent consultant ("Independent Consultant"), not unacceptable to the Commission staff. Grant Thornton shall provide to the Commission staff a copy of the engagement letter detailing the scope of the Independent Consultant's responsibilities. The Independent Consultant's compensation and expenses shall be borne exclusively by Grant Thornton. Grant Thornton shall deliver to the Independent Consultant the Grant Thornton Report at the same time as Grant Thornton provides such report to the Commission staff as specified in paragraph 168 above. Grant Thornton shall require that the Independent Consultant perform a review (the "IC Review") of Grant Thornton's Policies to determine whether Grant Thornton's Policies are adequate and sufficient to provide reasonable assurance of compliance with all relevant Commission regulations and PCAOB standards and rules. Grant Thornton shall cooperate fully with the Independent Consultant and shall provide reasonable access to firm personnel, information, and records as the Independent Consultant may reasonably request for the IC Review (including training materials pertaining to the undertaking in paragraph 173), subject to Grant Thornton's right to withhold from disclosure any information or records protected by any applicable protection or privilege such as the attorney-client privilege or the attorney work product doctrine.

170. <u>Independent Consultant's Report.</u> After the IC Review is completed, but no later than ninety days after receiving the Grant Thornton Report, the Independent Consultant shall issue a detailed written report (the "IC Report") to Grant Thornton: (a) summarizing the IC Review; and (b) making recommendations, where appropriate, reasonably designed to ensure that Grant Thornton's Policies are adequate and sufficient to provide reasonable assurance of compliance with all relevant Commission regulations and PCAOB standards and rules. Grant Thornton shall require the Independent Consultant to provide a copy of the IC Report to the Commission staff and the PCAOB staff when the IC Report is issued.

171. Grant Thornton shall adopt, as soon as practicable, all recommendations of the Independent Consultant in the IC Report. Provided, however, that within thirty days of issuance of the IC Report, Grant Thornton may advise the Independent Consultant in writing of any recommendation that it considers to be unnecessary, outside the scope of this Order, unduly burdensome, or impractical. Grant Thornton need not adopt any such recommendation at that time, but instead may propose in writing to the Independent Consultant and the Commission staff an alternative policy or procedure designed to achieve the same objective or purpose. Grant Thornton and the Independent Consultant shall engage in good-faith negotiations in an effort to reach agreement on any recommendations objected to by Grant Thornton. In the event that the Independent Consultant and Grant Thornton are unable to agree on an alternative proposal within sixty days, Grant Thornton shall abide by the determinations of the Independent Consultant.

172. <u>Certification by Grant Thornton's CEO</u>. Within sixty days of issuance of the IC Report, but not sooner than thirty days after a copy of the IC Report is provided to the Commission staff, Grant Thornton's chief executive officer ("CEO") must certify to the Commission staff in writing that (i) Grant Thornton has adopted and has implemented or will implement all recommendations of the Independent Consultant, if any; and (ii) the Independent Consultant agrees with Grant Thornton's adoption and implementation of the recommendations. To the extent that Grant Thornton has not implemented all recommendations of the Independent Consultant within sixty days of issuance of the IC Report, Grant Thornton's CEO must certify to the Commission staff in writing, thirty days after their implementation, that (i) Grant Thornton has adopted and has implemented all recommendations of the Independent Consultant; and (ii) the Independent Consultant agrees that the recommendations have been adequately adopted and implemented by Grant Thornton. The certifications by Grant Thornton's CEO 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 Grant Thornton agrees to provide such evidence.

173. <u>Training</u>. Prior to November 30, 2016, Grant Thornton shall require each audit professional serving public company audits to complete successfully a minimum of 32 hours of audit-related training. The audit-related training shall cover the topics specified in Paragraph 167. However, the following topics should be accorded the training hours noted below:

a) At least 8 hours shall be devoted to the importance of exercising due care and professional skepticism in evaluating audit evidence;

b) At least 4 hours shall be devoted to procedures and techniques used in auditing estimates;

c) At least 4 hours shall be devoted to the auditor's responsibilities with respect to ~~reviews of interim financial information, specifically focusing on circumstances~~ where extended procedures are appropriate (as discussed in AU § 722.22);

d) At least 8 hours shall be devoted to fraud-detection training. The training shall include techniques in detecting and responding to possible fraud in the course of public company audits by audit clients or by employees, officers or directors of audit clients. Particular attention should be focused on the auditor's consideration of the impact of audit findings on the assessment of fraud risks as discussed in AS 14 (Par. 28-29), as well as the documentation requirements outlined in AU § 316.83. Such training will also include the auditor's responsibilities under Section 10A of the Exchange Act; and

e) At least 4 hours shall be devoted to appropriate reliance on management representations.

174. To ensure the independence of the Independent Consultant, Grant Thornton: (1) shall not have the authority to terminate the Independent Consultant or substitute another independent compliance consultant for the initial Independent Consultant, without the prior written approval of the Commission staff; and (2) shall compensate the Independent Consultant and persons engaged to assist the Independent Consultant for services rendered pursuant to this Order at their reasonable and customary rates.

175. Grant Thornton shall 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 Grant Thornton, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement shall 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 this Order shall not, without prior written consent of the Division of Enforcement, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Grant Thornton, 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.

176. Grant Thornton shall not be in, and shall not have an attorney-client relationship with the Independent Consultant and shall not seek to invoke the attorney-client privilege or any other doctrine or privilege to prevent the Independent Consultant from transmitting any information, reports, or documents to Commission staff.

177. Grant Thornton shall inform its audit professionals of the terms of the Order within ten business days after entry of the Order.

178. By December 31, 2016, Grant Thornton's CEO shall certify, in writing, compliance with the undertakings set forth in paragraphs 173 and 177. 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 Grant Thornton agrees to provide such evidence.

179. Annual Certifications. With respect to each of the calendar year periods 2017 and 2018, Grant Thornton's National Managing Partner, Audit Risk Management ("Managing Partner") shall certify that Grant Thornton has assessed whether Grant Thornton's Policies are adequate and sufficient to provide reasonable assurance of compliance with all relevant Commission regulations and PCAOB standards and rules by, among other things, testing the firm's implementation of Grant Thornton's Policies during the twelve (12) months preceding the certification ("Annual Certification"). The Annual Certification shall describe the nature and scope of Grant Thornton's testing. The Annual Certification shall represent that the Managing Partner has reviewed and evaluated the firm's assessment and testing process and that, based on belief and after reasonable inquiry, the Managing Partner believes that Grant Thornton's Policies are adequate and sufficient to provide reasonable assurance of compliance with all relevant Commission regulations and PCAOB standards and rules. If the Managing Partner cannot represent that Grant Thornton's Policies are adequate and sufficient, then the Managing Partner shall describe in reasonable detail the reasons for the inability to so certify. The Managing Partner shall provide the Annual Certifications to the Commission's staff within sixty days of the end of the annual period. Grant Thornton shall preserve and retain all documentation regarding the Managing Partner's Annual Certification for seven (7) years and will make it available to the staffs of the Commission or the PCAOB upon request.

180. All reports and certifications mentioned in these undertakings shall be submitted to Robert Burson, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, 175 W. Jackson Blvd., Suite 900, Chicago, IL 60604, with a copy to the Office of Chief Counsel of the Enforcement Division.

181. 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.

182. In determining whether to accept Grant Thornton's Offer, the Commission has considered these undertakings. Grant Thornton agrees that if the Division of Enforcement believes that Grant Thornton has not satisfied these undertakings, it may petition the Commission to reopen the matter to determine whether additional sanctions are appropriate.

## IV.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Grant Thornton shall cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-1and 13a-13 thereunder.

B. Grant Thornton is censured.

C. Grant Thornton shall comply with the undertakings enumerated in Section H above.

D. Grant Thornton shall within 14 days of the entry of this Order, pay disgorgement of $1,305,396, which represents profits gained as a result of the conduct described herein and prejudgment interest of $231,174.19, to the Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600.

E. Grant Thornton shall pay a civil penalty of $3 million to the Commission within 14 days of the entry of this Order for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made additional interest shall accrue pursuant to 31 U.S.C. 3717.

F. Payments ordered in paragraphs D and E above 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 Grant Thornton 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 Robert Burson, Chicago Regional Office, Securities and Exchange Commission, 175 West Jackson, Suite 900, Chicago, IL 60604.

By the Commission.

Brent J. Fields
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. 9983 / December 3, 2015**

**SECURITIES EXCHANGE ACT 1934**
**Release No. 76546 / December 3, 2015**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 31926 / December 3, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16978**

| | |
|---|---|
| **In the Matter of**<br><br>**Behruz Afshar, Shahryar Afshar, Richard F. Kenny, IV, Fineline Trading Group LLC, and Makino Capital LLC,**<br><br>**Respondents.** | **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 SECTION 9(b) OF THE INVESTMENT COMPANY 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 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 Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Behruz Afshar ("Behruz") and Richard F. Kenny, IV ("Kenny"). Further, the Commission deems it appropriate and in the public interest that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act against Shahryar Afshar ("Shahryar"), Fineline Trading Group LLC ("Fineline"), and Makino Capital LLC ("Makino").

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## II.

After an investigation, the Division of Enforcement alleges that:

## SUMMARY

1. This case involves the perpetration of two fraudulent trading schemes by Behruz Afshar ("Behruz") and his twin brother, Shahryar Afshar ("Shahryar"), and their close friend, Richard F. Kenny, IV ("Kenny"): the mismarking of option orders to obtain "customer priority" and "spoofing" to generate liquidity rebates. The Afshars are sophisticated options traders and former registered representatives. Kenny, during the relevant time period, was a registered representative at Lightspeed Trading, LLC ("Lightspeed"). The Afshars and Kenny conducted the schemes through two Lightspeed accounts in the name of Fineline Trading Group LLC ("Fineline") and Makino Capital LLC ("Makino"), limited liability companies which the Afshars owned.

2. The first fraudulent scheme involved the mismarking of option orders to take advantage of the benefits that certain exchanges provide to non-professional, public retail investors. These exchanges, including the Chicago Board Options Exchange, the NYSE AMEX Options, the International Securities Exchange, and Nasdaq OMX PHLX ("PHLX"), require option orders from the accounts of public customers (not broker-dealers or market-makers) to be marked as either "customer" or "professional."

3. Orders marked "customer" have priority of execution over, and earn higher rebates and incur lower fees than, orders marked "professional" at the same price. A non-broker-dealer person or entity that places more than 390 orders in listed options per day (on average)—whether executed or not—on any listed options exchange during any calendar month in a quarter will be designated as a "professional" for the next quarter. Conversely, a "customer" is a non-broker-dealer person or entity that does not exceed the 390-order threshold for each calendar month in a quarter.

4. Despite far exceeding the 390-order threshold for every quarter from October 2010 to December 2012, the Respondents were able to continually place "customer"-marked orders throughout this time period by shifting their trading operations on a quarterly basis between the accounts of Fineline and Makino. When Fineline was designated as "professional" for an upcoming quarter, the Afshars' trading operations transitioned that quarter to Makino's account (designated as "customer"), essentially ceasing activity in Fineline's account. Fineline's inactivity would ensure that its account fell below the 390-order threshold, thereby achieving "customer" status for the next quarter, and thus enabling the trading to continue with the benefits of "customer" designation for that subsequent quarter (while trading in Makino essentially ceased).

5. The Afshars and Kenny accomplished this back-and-forth scheme through false representations to Lightspeed that Behruz solely owned Fineline and that Shahryar solely owned Makino, when in fact Behruz had an ownership interest in both companies. Kenny facilitated the

movement of funds and trading operations between the accounts. He also traded in the Afshars' accounts, received a portion of their trading gains, and shared his commissions with the Afshars.

6. By placing orders improperly marked as "customer," the Respondents deceived several exchanges—reaping over $2 million in transaction fees wrongly avoided and higher rebates wrongly received—and unfairly disadvantaged other market participants with orders that received execution priority.

7. The second fraudulent scheme involved manipulative trading known as "spoofing" to collect rebates from the PHLX. During the relevant time period, the PHLX employed a "maker-taker" fee model that offered rebates for orders that provided—or "made"—liquidity (i.e., orders that are posted to the exchange's order book before executing against a subsequent incoming order) and charged fees for orders that "took" liquidity (i.e., orders that execute immediately against previously-received, liquidity-providing orders).

8. Between May 2011 and December 2012, the Respondents placed All-Or-None ("AON") orders—undisplayed orders that must be executed in their entirety or not at all—in options on the PHLX to generate liquidity rebates. The Respondents then placed smaller orders in the same option series and price as the larger AON orders, but on the opposite side of the market. These small-lot orders, which were displayed, were not bona fide orders because they were not intended to be executed. Instead, they were placed to alter the option's best bid or offer ("BBO") in order to induce, or "spoof," other market participants into submitting orders at the new BBO, which would then execute against the AON orders. Upon execution of those AON orders, any open displayed orders placed by the Respondents were cancelled.

9. Because the executed AON orders existed prior to the entry of the other market participants' orders, they were deemed to have added liquidity and, thereby, generated rebates. In contrast, the other market participants, tricked into trading against the AON orders, were assessed a "take" fee. As a result of this manipulative trading scheme, the Afshars reaped over $225,000 in ill-gotten rebates.

## RESPONDENTS

10. **Behruz Afshar**, age 44, of Chicago, IL, worked at Terra Nova Financial, LLC ("Terra Nova"), a registered broker-dealer, from February 1997 to August 2007. While at Terra Nova, Behruz was the firm's head trader, managing and supervising all trading operations of the broker-dealer. Behruz was also associated with another registered broker-dealer from October 2009 to December 2011. In March 2008, Behruz started his own trading company, Fineline, which began trading through a master sub-account at Terra Nova. During the relevant time period, Fineline traded through a master sub-account at Lightspeed. Behruz employed traders on an independent contracting basis to trade in Fineline's sub-accounts. Behruz held Series 3, 4, 7, 24, 53, 55, and 63 licenses.

11. **Shahryar Afshar**, age 44, of Chicago, IL, is the twin brother of Behruz and was a registered representative with Terra Nova from 1998 to 1999, and from March 2005 to October

2005, and with various other broker-dealers from 2000 to 2004. In December 2010, together with Behruz and Kenny, Shahryar formed and took an ownership interest in Makino, which traded through a master sub-account at Lightspeed. Makino utilized the same independent contracting traders as Fineline to trade in its sub-accounts. Shahryar held Series 3, 7, 55, and 63 licenses.

12. **Richard F. Kenny, IV**, age 45, of Chicago, IL, was a registered representative at Terra Nova from 1996 to 1998 and from January 2005 until October 2010, when he became a registered representative at Lightspeed as a result of Lightspeed's acquisition of Terra Nova. Kenny held Series 3, 7, 24, 55, and 63 licenses. Kenny resigned from Lightspeed in December 2013, due to his refusal to formally attest that he was not sharing his commissions with any customers or non-registered individuals. On October 2014, FINRA filed a complaint against Kenny for repeatedly refusing to respond to informational requests in connection with its investigation of the Afshars' trading activity. In June 2015, FINRA issued a decision against Kenny for his failure to provide information and documents that would have identified the Afshars and bank accounts in their names or under their control. FINRA's decision, which became final in July 2015, barred Kenny from association with any FINRA member firm and ordered him to pay costs.

13. **Fineline Trading Group LLC** is a Nevada limited liability company that Behruz formed in December 2007. Fineline is a trading company through which Behruz, during the relevant time period, employed up to four independent contracting traders to trade in its sub-accounts. Behruz and Kenny also traded in Fineline's sub-accounts. Behruz controlled and handled all of Fineline's trading operations, risk management, and accounting.

14. **Makino Capital LLC** is a Nevada limited liability company that Shahryar, Behruz, and Kenny formed in December 2010. Makino utilized the same independent contracting traders as Fineline to trade in its master sub-account. Shahryar, Behruz, and Kenny also traded in Makino's sub-accounts. Behruz controlled and handled all trading operations, risk management, and accounting for Makino.

## OTHER RELEVANT ENTITIES

15. **Lightspeed Trading LLC** is a New York limited liability company that was formed in 1998. Lightspeed is a broker-dealer registered with the Commission pursuant to Section 15(b) of the Exchange Act. Lightspeed's principal place of business is in New York, New York; the firm also has a branch office in Chicago. Lightspeed, which acquired Terra Nova in 2010, is a member of FINRA and various exchanges.

16. **Third Rail Management, Inc. ("Third Rail")** is a Nevada S corporation that Kenny formed in 2008. During the relevant time period, among other things, Third Rail's bank account facilitated monetary transfers between the checking accounts of Fineline and Makino.

## FACTS

### A. The Afshar Brothers and Kenny

17. The Afshar brothers and Kenny are close friends. They attended the same middle school and college, and had overlapping tenures at Terra Nova where Behruz was director of the firm's trading operations, and where Kenny and Shahryar were registered representatives.

18. In October 2010, Kenny became a registered representative at Lightspeed as a result of Lightspeed's acquisition of Terra Nova. Kenny, although a registered representative with Lightspeed, was considered an independent contractor or "external broker" of the firm.

19. Kenny brought with him to Lightspeed some of the customer accounts he personally serviced while at Terra Nova, including his two largest customers, Behruz and Shahryar and their accounts, most notably, Fineline.

20. During his tenure at Lightspeed, Kenny, as an "external broker," was not required to work at the firm's registered office in Chicago, but operated alongside Behruz at a trading desk they leased on one of the floors of the Chicago Stock Exchange, Inc. Shahryar traded from his home or at one of the terminals at his brother's and Kenny's rented trading desk.

21. Kenny helped Behruz form Fineline and Makino by filing the formation documents with the state of Nevada and serving as Fineline's resident agent. Kenny was also Fineline's registered representative at Terra Nova (and later at Lightspeed) and Makino's registered representative at Lightspeed, earning commissions on trades in their accounts. Kenny, along with Behruz, was also a signer on the companies' checking accounts and a named cardholder of Fineline's business credit card. Kenny also invested in Makino, together with the Afshars.

22. During the relevant time period, Fineline and Makino employed at least four traders on an independent contracting basis to trade in the companies' sub-accounts, using trading capital provided by the Afshars.

23. Generally, a master sub-account is an account at a broker-dealer where a top-level customer, in most instances a limited liability company or limited liability partnership, is allowed to have subordinate accounts for different trading activities. These subordinate, or sub-, accounts are then typically used by individual traders or groups of traders.

24. Three of the independent contracting traders of Fineline and Makino traded in the same office space in San Francisco, and the other trader was a friend of the Afshars who traded primarily alongside Behruz and Kenny at their trading desk.

25. The master sub-account arrangement with portfolio margining afforded the traders increased "buying power" and leverage as each trader could trade on margin against the value of

the entire Fineline or Makino master account. The traders agreed to split their respective net gains with the Afshars on a 50-50 basis.

26. Behruz oversaw all of the activity of the sub-account traders of Fineline and Makino on a real-time basis, kept track of their order counts, provided operational, risk-management, and technological support, as well as access to trading software to place and route orders to specific exchanges. Behruz also controlled and handled the traders' capital and managed all accounting, including determining the sub-account traders' payouts and expense reimbursements, and ensuring that the companies' trading profits (after compensating the sub-account traders) were split three ways—among himself, Shahryar, and Kenny.

27. Behruz and Kenny also kept track of, on a monthly basis, the exchanges' maker-taker pricing models and fee schedules and informed the sub-account traders of any changes.

28. From October 2010 to December 2013, Kenny earned approximately $2 million in commissions, of which over $1.5 million was earned from the Afshars' accounts. Kenny shared those commissions with the Afshars and personally traded in the sub-accounts of both Fineline and Makino. This conduct, which Kenny failed to disclose to Lightspeed, violated the broker-dealer's written supervisory procedures.

**B. <u>The "Professional" Order Type for Options</u>**

29. A "professional order" is defined as an order for the account of a person or entity that: (1) is not a broker or dealer in securities; and (2) places more than 390 orders in listed options per day – whether executed or not – on any listed options exchange on average during any calendar month of a quarter for its own beneficial account(s) ("390-order threshold"). Three hundred ninety orders is equal to the total number of orders that a person would place in a day if that person entered one order every minute from market open to market close.

30. A "customer priority" order is defined as an order for the account of a non-broker-dealer person or entity that falls below the 390-order threshold for each calendar month in a quarter.

31. All orders for multiple accounts beneficially owned or controlled by the same person or entity, and all sub-accounts of a person or entity's master account, must be aggregated when determining whether the 390-order threshold has been exceeded by that person or entity.

32. A "customer priority" order is given priority of trade execution over "professional" and broker-dealer orders at the same price and, with few exceptions, does not incur any transaction fees and receives higher rebates (or pays lower fees) for adding (or removing) liquidity. Options exchanges provide these benefits to customer priority orders to attract retail order flow and level the playing field for retail investors over market professionals.

33. Lightspeed coded orders as "customer" or "professional" based on a quarterly counting of its customers' orders. Orders from accounts with the same beneficial ownership

(including all sub-accounts under a master account) were aggregated and totaled on a per-month basis to determine whether an account exceeded the 390-order threshold. Because trading activity was reviewed quarterly to determine whether orders for an account should be represented as "professional" or "customer," a professional account one quarter can become a customer account next quarter, and vice versa, depending on the previous quarter's order count.

### C. The "Customer-Priority" Scheme

#### 1. The Scheme Generally

34. From at least December 2010 to December 2012, the Afshars and Kenny perpetrated a scheme to fraudulently maintain "customer"-designation of all the orders from the Afshars' accounts without interruption despite their order counts at Lightspeed far exceeding the 390-order threshold for every month during that time period.

35. The scheme was accomplished by having the trading operations at Lightspeed alternate between the Fineline and Makino accounts each quarter, depending on which account was "customer"-designated, with the other "professional" account conducting little to no activity.

36. Both Kenny and Behruz knew Lightspeed's quarterly review procedures which required the aggregation of orders for all beneficially owned accounts (and their sub-accounts, if any existed). Kenny also read industry guidance regarding the requirement to aggregate orders and the exchanges' prohibition on avoiding the "professional" designation by spreading trading activity over multiple accounts.

37. Typically, at the end of each quarter, Kenny or Behruz sought confirmation from Lightspeed that either the Fineline or Makino account would be designated as "professional" and that the other account would "come off pro" and revert back to "customer."

38. After receiving confirmation from Lightspeed that the mostly dormant "professional" account would return to "customer" status at the start of the next quarter, Behruz alerted the sub-account traders of their upcoming transition to a new account and required them to wind down any open positions. Kenny ensured that the sub-account traders had trading authority and proper access credentials to seamlessly move between accounts. He also assisted the Afshars in transferring sufficient trading capital between the two master sub-accounts to enable the trading operations to continue without interruption.

39. To avoid account aggregation, the Afshars and Kenny misrepresented to Lightspeed that Fineline and Makino did not share common ownership, representing that Behruz was the sole beneficial owner of the former, and Shahryar was the sole beneficial owner of the latter.

40. In fact, Behruz had a beneficial interest in both Fineline and Makino. Fineline's account opening documents, signed by Behruz and submitted to Lightspeed, listed Behruz as the only individual with a beneficial interest in the company. Fineline's incorporation documents

also reflect that Behruz was the sole managing member of the company during the relevant time period.

41. For Makino, according to an email from Shahryar to Behruz and Kenny in June 2011, Behruz initially invested $27,500 in the company. At the time, this was at least a third of the total amount invested in Makino.

42. Had Lightspeed known that Behruz in fact controlled and managed both companies' accounts and had a beneficial interest in Makino, or that both companies' trading profits (after paying the sub-account traders) were divided among the Afshars and Kenny, the accounts of Fineline and Makino would have been marked "professional" for every quarter during the relevant time period.

### 2. The Genesis and Intent of the Customer-Priority Scheme

43. The scheme took shape in December 2010, when Behruz and Kenny, fully aware of the aggregation requirements of orders from beneficially owned accounts, explored ways to ensure that Fineline's trading continued in a "customer"-marked account for the first quarter of 2011. Behruz and Kenny initially sought to open a new master sub-account at another broker-dealer. In mid-December 2010, Behruz forwarded to one of the sub-account traders an email from the other broker-dealer about the availability of a new master sub-account for trading by January 3, 2011, stating, "[b]elow is an email from my guy at the other BD we plan on trading soon.... In case you were wondering, we plan on having accounts open at multiple firms under different names so we can keep trading :)."

44. The idea of opening an account at the other broker-dealer was abandoned when Lightspeed's compliance department refused to approve Kenny's dual association with the other broker-dealer.

45. Behruz, Kenny, and Shahryar ultimately decided to form a new entity, Makino, named after a sushi restaurant in Las Vegas, Nevada that Shahryar frequented, open a master sub-account in its name at Lightspeed, and then make it appear that Makino was not beneficially owned by Fineline and/or Behruz. As Behruz explained to a sub-account trader via instant message:

> *Behruz*: i'm always about the money, the problem that we face is Monday [January 3, 2011] we are Pro[fessional]...that doesn't change
> *Behruz*: I was ready to have a customer account for [sic] to trade in as of last week, but some powers that may be came in and put some strain on that account so we had to go another route which will still accomplish our goal....
> *Behruz*: you should see all the s*** we're doing here...too funny
> *Sub-Account Trader*: costume party? what do you mean?
> *Behruz*: opening bank accounts, trading accounts, etc ....

*Behruz*: i think we have about 10 llc here all tied to sushi names
*Sub-Account Trader*: LOL
*Sub-Account Trader*: you and your fish man
*Sub-Account Trader*: too funny
*Behruz*: i'm not even the one that came up with these damn names
*Sub-Account Trader*: haha who made em up
*Behruz*: my bro and rich

46. Kenny filed paperwork with the state of Nevada to form Makino on December 20, 2010. Those formation documents included Shahryar as the only principal of the company despite the fact that Behruz and Kenny also had a beneficial interest in the company—all three each initially invested $27,500. One week later, Kenny completed and submitted an application to Lightspeed for a new master sub-account for Makino. That application, signed by Shahryar, falsely stated that Shahryar was the sole beneficial owner of Makino.

47. Once Makino's master sub-account was approved by Lightspeed in mid-January 2011, Fineline's trading, with Behruz managing the operations and Kenny serving as the registered representative (and an unofficial sub-account trader), was able to continue as a "customer"—for the first quarter of 2011 in the new Makino account—and for all subsequent quarters in the relevant time period as those operations seamlessly alternated between the two accounts.

48. By the fourth quarter of 2012, Behruz became frustrated with aggregating the sub-account traders' orders for purposes of determining the 390-order threshold, and confided in a former colleague from Terra Nova that it was time to "kill the whole idea of having these master sub setups and having individual traders being just backed and they have to monitor their order counts. That way we don't – they don't have to f***in' bounce around" between Fineline and Makino.

49. As a result, starting in January 2013, the Respondents' plan was for each sub-account trader to establish their own LLC, open an account at Lightspeed in the name of that LLC in which to trade, and have Fineline "operate as we always have, but more as a lender of capital," controller of all the "money flow," and recipient of a split of the traders' respective net gains. "The idea," as Behruz wrote, "[was] to function in a capacity where [Fineline] will not have beneficial ownership but will still be able to provide traders with the same service" and with trading capital. Moreover, each trader had to "adhere to the 390 rule or else run the risk of being coded pro-customer."

### 3. Specific Example of the Customer-Priority Scheme

50. The Respondents placed the following number of orders in the fourth quarter of 2011:

| Month | Account Name | Account Designation | Aggregate Orders | Daily Average |
|---|---|---|---|---|
| October 2011 | Fineline Trading Group LLC | Customer | 91,250 | 4,345 |
| | Makino Capital LLC | Professional | 78 | 4 |
| November 2011 | Fineline Trading Group LLC | Customer | 76,916 | 3,663 |
| | Makino Capital LLC | Professional | 2 | 0.10 |
| December 2011 | Fineline Trading Group LLC | Customer | 80,134 | 3,816 |
| | Makino Capital LLC | Professional | 0 | 0 |

51. In anticipation of Fineline becoming designated as "professional" for the first quarter of 2012 based on the order counts above, Kenny began the process of re-activating the Makino sub-accounts in late December 2011.

52. On December 27, 2011, Kenny emailed a representative in Lightspeed's accounts department requesting log-in credentials for the Makino sub-accounts. In his email, Kenny falsely represented that only Shahryar would be trading in each of the sub-accounts and that Shahryar was the only member of Makino, attaching trade authorization forms signed by Shahryar listing only his name for each sub-account. On December 30, 2011, Kenny received the log-in credentials.

53. As part of ensuring a seamless transition of trading operations from Fineline to Makino for the start of the first quarter of 2012, Behruz transferred trading capital from Fineline to Makino through an entity owned by Kenny.

54. On December 30, 2011, Behruz submitted a wire request to Lightspeed to transfer $420,000 from Fineline's brokerage account to its checking account. After receiving those funds, on the same day, Fineline's checking account transferred $220,000 to a checking account in the name of Third Rail, an entity Kenny owned and which helped facilitate money transfers between Fineline and Makino, with the remaining $200,000 transferred to Makino's checking account (increasing Makino's account balance to over $400,000).

55. On January 3, 2012, Third Rail transferred $200,000 to Makino's checking account (increasing its account balance to more than $600,000). Later that day, Makino transferred $600,000 to its brokerage account at Lightspeed and Kenny emailed the sub-account traders their respective log-in credentials received from Lightspeed's accounts department to begin trading in the Makino sub-accounts.

56. The next day, January 4, Third Rail's checking account transferred $250,000 to Makino's checking account, all of which Makino then transferred to its brokerage account at Lightspeed, providing additional trading funds.

57. Third Rail's involvement in the transfers between Fineline and Makino was intended to avoid raising suspicions that the two companies were affiliated.

58. The following shows the shifting of trading activity from Fineline's account to Makino's account (now "customer") in the first quarter of 2012:

| Month | Account Name | Account Designation | Aggregate Orders | Daily Average |
|---|---|---|---|---|
| January 2012 | Fineline Trading Group LLC | Professional | 438 | 21 |
| | Makino Capital LLC | Customer | 97,122 | 4,625 |
| February 2012 | Fineline Trading Group LLC | Professional | 16 | 0.8 |
| | Makino Capital LLC | Customer | 100,187 | 5,009 |
| March 2012 | Fineline Trading Group LLC | Professional | 12 | 0.55 |
| | Makino Capital LLC | Customer | 107,232 | 4,874 |

59. On March 29, 2012, Kenny requested, and received, confirmation from Lightspeed that Fineline's designation would revert back to "customer" at the start of the second quarter based on the order counts above. Later that day, Kenny requested that Lightspeed "expire" the Makino log-in credentials used by the sub-account traders and "enable" four Fineline log-in credentials, effective Monday, April 2, 2012, the first trading day of the next quarter.

60. As part of transitioning the trading operations from Makino back to Fineline for the start of the second quarter of 2012, Makino transferred trading capital to Fineline. On Friday, March 30, 2012, Makino requested a wire transfer of $730,000 from its Lightspeed account to its checking account. On April 2, 2012, Makino transferred $500,000 and $80,000 to Third Rail's and Fineline's checking accounts, respectively, and Kenny emailed the sub-account traders their new log-in credentials for the re-activated Fineline sub-accounts. On April 4, 2012, Third Rail transferred $300,000 to Fineline's checking account. Several days later, on April 9, 2012, Fineline transferred $400,000 to its Lightspeed account providing additional trading funds.

### 4. The Deceived Parties of the Customer-Priority Scheme

61. The "customer priority" scheme was intended to deceive, and did deceive, the exchanges which required option orders from public customers to be designated as either "customer" or "professional." On the basis of that order designation, the exchanges determined which orders received priority of execution and the amounts of all related transaction credits and debits, including liquidity rebates, "take" fees, transaction costs, and cancellation fees. Lightspeed passed on the full amount of these credits and debits from the exchanges to the corresponding customers that placed the orders.

62. As a result, the customer-priority scheme netted the Afshars' accounts over $2 million in exchange fees avoided and additional rebates earned from the exchanges.

63. In addition, the scheme unfairly disadvantaged other professional market participants over whom the Respondents' "customer" orders would have wrongly received priority of execution for orders at the same price. Put another way, professional public customers placing orders at the same price as Respondents' orders would have been harmed by the Respondents' advantageous position of execution priority through the customer-priority scheme.

64. The Respondents' trading operations and the volume and frequency of their orders in no way resembled those of a non-professional, retail customer. The Respondents undermined the purpose of the "professional"-order type, which was to level the playing field between public customers and professional traders, by wrongly claiming for themselves the benefits exchanges only offered to non-professional, public customers.

### D. The "Spoofing" Scheme

#### 1. The Scheme Generally

65. Between May 2011 and December 2012, the Respondents engaged in "spoofing" to generate rebates from the PHLX, which was a maker-taker exchange at the time. In general, spoofing describes a trader's use of "non-bona fide" orders (i.e., orders that the trader does not intend to have executed) in a security on one side of the market, which affect the price and/or volume of that security, for the purpose of inducing other market participants to execute against the trader's orders in the same security but on the opposite side of the market. The spoofing employed by the Respondents focused on options in symbols that were eligible for rebates on the PHLX.

66. The Respondents, or the sub-account traders under the Respondents' direction and/or supervision, entered a series of nondisplayed AON orders to buy (or sell) options on the PHLX in these symbols at a price that was a penny more (or less) than the option's current best bid (or offer). AON orders are undisplayed orders to buy or sell securities that must be executed in their entirety, or not executed at all. AON orders continue to remain active (and hidden) until they are executed or cancelled. Because AON orders are undisplayed, their prices do not affect the national best bid or offer ("NBBO").

67. The Respondents, or the sub-account traders under the Respondents' direction and/or supervision, then placed smaller, non-bona fide sell (or buy) orders—typically, for one contract ("a one-lot")—on the PHLX (or a different exchange) at the same price as the AON orders, but on the opposite side of the market (the "small-lot orders"). Because the size of the small-lot orders was less than the AON orders, those orders did not execute against each other. The small-lot orders, which were displayed, were placed for the purpose of lowering (or raising) the option's best offer (or bid) by one penny in order to induce other market participants to send orders on the same side at that price level. Once other market participants joined the small-lot order with sufficient quantity, their orders executed against the AON orders. After the AON orders were filled, any open, non-bona fide, small-lot order was cancelled. Typically, the strategy was repeated on the opposite side of the market to close out the position.

68. Because the AON orders were posted to the PHLX's order book before executing against subsequently received orders, the PHLX credited them with having provided liquidity and paid rebates that Lightspeed passed on to the Afshars' accounts. Conversely, the orders from the other market participants, who were "spoofed" into executing against the pre-existing AON orders, were considered to have removed liquidity and charged a "take" fee by the PHLX.

69. Once the PHLX removed their maker-taker pricing schedule for "customer"-marked orders effective January 2013, the AON spoofing scheme came to an end, or as Behruz summed it up, "bye bye AON fun." As a result of this scheme, the Afshars' accounts generated over $225,000 in rebates from the PHLX.

70. The use of small-lot orders to spoof other market participants into executing against the non-displayed AON orders was described by Behruz as the "hidden X-A," referring to the coding of orders that earned rebates from the PHLX ("X" for PHLX and "A" for adding liquidity) and described by Kenny as "bringing in the offer" (to fill AON buy orders) or "bringing in the bid" (to fill AON sell orders), as reflected in instant messages:

> *Behruz*: i love getting 'em with the hidden x-a anyhow . . . bring me such pleasure and joy . . . at times I roll over laughing
> *Sub-Account Trader*: haha
> *Sub-Account Trader*: yes
> *Sub-Account Trader*: it's a nice feeling
> *Sub-Account Trader*: I love it when I use nasd [to place the small-lot order] to bring the bid/offer in and then get em
>
> ------------------
>
> *Sub-Account Trader*: did you see the [Microsoft trade] [last] month?
> *Sub-Account Trader*: yday
> *Sub-Account Trader*: no liquidity
> *Kenny*: i didn't…you get some?
> *Sub-Account Trader*: but i offered em on phlx aon and brought the bid in on phlc [sic]
> *Sub-Account Trader*: i LOVE doin that lol …
> *Kenny*: that is the finest... bringing in the bid or offer
> *Kenny*: makes you feel proactive!
> *Sub-Account Trader*: makes me feel like i was smarter than the computer haha
> *Kenny*: true dat

## 2. A Specific Spoofing Example

71. On October 15, 2012, between 9:52:50 and 9:52:54, Kenny himself placed twelve AON orders, each to sell ten call option contracts of Ford, with November 2012 expiration and a strike price of $11.00, for $.08 on the PHLX (for a total of 120 contracts).

- At the time, the inside bid for this option series was $.07 and the inside offer was $0.09 and the bid size was over 2,400 contracts.
- The AON orders did not change the national best offer because they were not displayed to other market participants.
- Kenny placed the AON orders in one of the sub-accounts of Fineline, which was designated "customer" because its activity in the prior quarter fell below the 390-order threshold.

72. At 9:52:56, Kenny placed a one-lot order to purchase the same call option series in Ford for $0.08 on the PHLX from one of the sub-accounts of Makino, which at the time was designated "professional," presumably to avoid raising any suspicions of a wash trade and to decrease the likelihood of an execution (due to the lower priority of "professional" orders).

- The one-lot order raised the national best bid from $0.07 to $0.08—narrowing the NBBO spread from two cents ($0.07 x $0.09) to one cent ($0.08 x $0.09). At that one-cent spread, the bid size was only one contract—reflecting the one-lot order.
- That order was guaranteed not to execute against the AON orders because the quantity of the AON orders exceeded the one-lot.
- At 9:52:59, Kenny cancelled the one-lot order, which lowered the national best bid back to $0.07 (at which price the bid size was more than 2,300 contracts).

73. At 9:56:01, Kenny placed another one-lot buy order at $0.08 in the same call option series.

- The one-lot order increased the best bid to $0.08 (at which price the bid size was again one contract).
- At 9:56:03, Kenny placed six more AON sell orders in the same call option series at $0.08 (increasing the AON sell orders to 180 total contracts).
- Between 9:56:03 and 9:56:43, other market participants submitted buy orders at $0.08 in sufficient quantities to completely fill all eighteen AON orders.
- At 9:56:43, all eighteen AON orders were executed, resulting in $46.80 in liquidity rebates for the Fineline account ($0.26 per contract).

- At 9:56:45, Kenny cancelled the open one-lot order, dropping the best bid back to $0.07.

### 3. The Genesis and Intent of the Spoofing Scheme

74. Behruz developed the scheme, sometimes referred to as "AON-ing," or simply "AON," after he observed non-marketable orders from the Afshars' accounts—which he believed were eligible for rebates upon their execution—executed immediately and were charged a "take" fee for removing liquidity. After learning that the orders executed against hidden orders, Behruz began testing AON orders on the PHLX.

75. Behruz later learned that "customer"-marked AON orders were not assessed cancellation fees by the PHLX (unlike "professional" AON orders). This made the spoofing strategy economically viable because the Afshars' accounts could post AON orders and cancel them without penalty if they were not filled. As a result, in early May 2011, Behruz introduced the AON strategy to Kenny and the sub-account traders.

76. On some occasions, Behruz and Kenny placed small-lot orders on the PHLX to assist the sub-account traders in filling their AON orders, typically using a different sub-account (or the account designated as "professional" at the time). Kenny told one of the sub-account traders that "as far as AON goes, [Behruz] and i love to help. i love to positions [sic] get closed."

77. At times, the sub-account traders requested this assistance and other times, Behruz and Kenny proactively offered it. For example, Kenny wrote one sub-account trader: "that you AONing in MSFT? i'm gonna prop it up and get u filled" and, on another occasion, wrote: "lemme help you out. load up your aons." Similarly, Behruz corresponded with a trader:

> *Behruz*: … I'd rather do the phlx aon on that and bring the offer in
> *Sub-Account Trader*: ok . . .
> *Sub-Account Trader*: 10 50 lots?
> *Behruz*: yes
> *Sub-Account Trader*: ok done
> *Behruz*: when you're done we'll cancel the 1 lot
> *Behruz*: that's my offer
> *Sub-Account Trader*: k
> *Behruz*: come here kitty kitty
> *Behruz*: they are afraid :)

### 4. The Victims of the Spoofing Scheme

78. Market participants were deceived when they interpreted the small-lot orders as reflecting genuine demand or supply and joined those orders with hopes of offering liquidity and earning rebates. Instead, their orders often executed against the hidden AON orders and resulted in "take" fees. These market participants were deceived into executing against AON orders

placed from the Afshars' accounts at prices that had been artificially raised (or lowered) by those same accounts.

79. In fact, one market participant alerted the PHLX about being deceived by such trading. On October 31, 2012, a trader at a registered broker-dealer, market-maker, and proprietary trading firm, notified her supervisor, the head of the firm's U.S. options market making ("Head Trader #1"), that "[t]oday we saw in GE us remove large size on PHLX using quotes. We join a 1-lot bid and end up removing liquidity via 10-lot trades (the 1-lot remains). Last time we saw this behavior the exchange verified that we had crossed with an ALL-or-NONE order. I am curious if it is the same case here and if the counterparty we execute against is the same firm that has a 1-lot bid in the depth."

80. Unbeknownst to the firm, on October 31, 2012, from 12:29:31 to 12:29:43, Kenny, in one of Fineline's sub-accounts, placed twenty-four AON orders on the PHLX, each to sell ten contracts of GE (with November 2012 expiration and strike price of $22.00) for $0.07 (for a total of 240 contracts). At the time, the inside bid for this option was $0.06 (with a size of 1,897 contracts) and the inside ask was $0.08 (at 5,291 contracts). At 12:29:47, Kenny, from one of Makino's sub-accounts, placed a one-lot order on the PHLX to buy the same option at $0.07. That one-lot order raised the inside bid from $0.06 to $0.07 (with a bid size of one contract).

81. In response to that price movement, at 12:34:38, the firm's trading algorithm joined the one-lot order with an order to buy 130 contracts of the November 2012 GE option at $0.07 to provide liquidity at the new bid and potentially earn rebates. However, rather than providing liquidity, the firm's order immediately executed in full against thirteen of the preexisting twenty-four AON orders placed by Kenny. The firm's order thus removed liquidity and was charged a "take" fee by the PHLX. At 12:36:36, Kenny cancelled the one-lot order, moving the inside bid back to $0.06 (with a size of 602 contracts).

82. Several hours later, after being informed of these findings, Head Trader #1 emailed individuals at the PHLX about his concerns: "[W]e have encountered some strange trading behavior recently on PHLX. It appears like we are trading against hidden AON orders, and we believe that someone might be manipulating the market. Here is one example from today that we found in GE, all timestamps are CST. Before the trades happened the PHLX BBO was .07 bid at .08. The volume on the .07 bid was 1 contract. We tried to join the .07 bid for a size of 130 contracts, and we immediately traded 13 times, each trade was for 10 contracts. We are particularly concerned that a market participant is entering an order to buy 1 contract at .07 (not AON), and then they are layering many orders to sell at .07 using an AON contingency."

## VIOLATIONS

### A. The "Customer-Priority" Scheme

83. As a result of the conduct described above, Behruz and Kenny willfully violated, and Shahryar, Fineline, and Makino violated, Sections 17(a)(1) and 17(a)(2) of the Securities Act as well as Section 10(b) of the Exchange Act and Rules 10b-5(a), 10b-5(b), and 10b-5(c)

thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities.

84. As a result of the conduct described above, alternatively, Behruz willfully aided and abetted and caused Shahryar's, Fineline's, and Makino's violations of Sections 17(a)(1) and 17(a)(2) of the Securities Act as well as Section 10(b) of the Exchange Act and Rules 10b-5(a), 10b-5(b), and 10b-5(c) thereunder.

85. As a result of the conduct described above, alternatively, Kenny willfully aided and abetted and caused Behruz's, Shahryar's, Fineline's, and Makino's violations of Sections 17(a)(1) and 17(a)(2) of the Securities Act as well as Section 10(b) of the Exchange Act and Rules 10b-5(a), 10b-5(b), and 10b-5(c) thereunder.

86. As a result of the conduct described above, alternatively, Shahryar caused Makino's violations of Sections 17(a)(1) and 17(a)(2) of the Securities Act as well as Section 10(b) of the Exchange Act and Rules 10b-5(a), 10b-5(b), and 10b-5(c) thereunder.

87. As a result of the conduct described above, alternatively, Behruz, Shahryar, and Kenny acted through or by means of Fineline and Makino, as well as Lightspeed, and as a result, Behruz and Kenny willfully violated, and Shahryar violated, Section 20(b) of the Exchange Act, which prohibits a person, directly or indirectly, from doing any act or thing which it would be unlawful for such person to do under the Exchange Act or any rule or regulation thereunder, through or by means of any other person, and Section 10(b) of the Exchange Act and Rules 10b-5(a), 10b-5(b), and 10b-5(c) thereunder.

### B. <u>The "Spoofing" Scheme</u>

88. As a result of the conduct described above, Behruz and Kenny willfully violated, and Shahryar, Fineline, and Makino violated, Sections 17(a)(1) and 17(a)(3) of the Securities Act as well as Sections 9(a)(2) and 10(b) of the Exchange Act and Rules 10b-5(a) and 10b-5(c) thereunder, which prohibit fraudulent conduct in the offer and sale of securities and in connection with the purchase or sale of securities.

89. As a result of the conduct described above, alternatively, Behruz willfully aided and abetted and caused Shahryar's, Fineline's, and Makino's violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act as well as Sections 9(a)(2) and 10(b) of the Exchange Act and Rules 10b-5(a) and 10b-5(c) thereunder.

90. As a result of the conduct described above, alternatively, Kenny willfully aided and abetted and caused Behruz's, Shahryar's, Fineline's, and Makino's violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act as well as Sections 9(a)(2) and 10(b) of the Exchange Act and Rules 10b-5(a) and 10b-5(c) thereunder.

91. As a result of the conduct described above, alternatively, Shahryar caused Makino's violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act as well as Sections 9(a)(2) and 10(b) of the Exchange Act and Rules 10b-5(a) and 10b-5(c) thereunder.

92. As a result of the conduct described above, alternatively, Behruz, Shahryar, and Kenny acted through or by means of Fineline and Makino, and as a result, Behruz and Kenny willfully violated, and Shahryar violated, Sections 20(b), 9(a)(2), and 10(b) of the Exchange Act and Rules 10b-5(a) and 10b-5(c) 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 and cease-and-desist proceedings be instituted to determine:

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

B. What, if any, remedial action is appropriate in the public interest against Behruz and Kenny pursuant to Section 15(b)(6) of the Exchange Act including, but not limited to, disgorgement and civil penalties pursuant to Section 21B of the Exchange Act;

C. What, if any, remedial action is appropriate in the public interest against Behruz and Kenny pursuant to Section 9(b) of the Investment Company Act; and

D. Whether, pursuant to Section 8A of the Securities Act and Section 21C of the Exchange Act, the Respondents should be ordered to cease and desist from committing or causing violations of and any future violations of Section 17(a) of the Securities Act, and Sections 9(a)(2), 10(b), and 20(b) of the Exchange Act and Rule 10b-5 thereunder, and whether the Respondents should be ordered to pay a civil penalty pursuant to Section 8A(g) of the Securities Act and Section 21B(a) of the Exchange Act, and whether Respondents should be ordered to pay disgorgement pursuant to Section 8A(e) of the Securities Act, and Sections 21B(e) and 21C(e) of the Exchange Act.

## IV.

IT IS ORDERED that a public hearing for the purpose of taking evidence on the questions set forth in Section III hereof shall be convened not earlier than 30 days and not later than 60 days from service of this Order at a time and place to be fixed, and before an Administrative Law Judge to be designated by further order as provided by Rule 110 of the Commission's Rules of Practice, 17 C.F.R. § 201.110.

IT IS FURTHER ORDERED that the Respondents shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If the 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 the Respondents as provided for in the Commission's Rules of Practice.

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.

Brent J. Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 4287 / December 3, 2015

Admin. Proc. File No. 3-15950

| In the Matter of<br><br>S.A.C. CAPITAL ADVISORS, L.P.<br>S.A.C. CAPITAL ADVISORS, LLC<br>CR INTRINSIC INVESTORS, LLC<br>SIGMA CAPITAL MANAGEMENT, LLC<br>PARAMETER CAPITAL MANAGEMENT, LLC<br>72 CREDIT MANAGEMENT, LLC<br>S.A.C. PRIVATE EQUITY GP, L.P.<br>POINT72 ASIA (HONG KONG) LIMITED<br>POINT72 ASIA (NORTH ASIA) LIMITED<br>and<br>POINT72 ASIA (SINGAPORE) PTE. LTD<br><br>Respondents. | ORDER GRANTING MOTION TO AMEND ORDER INSTITUTING PROCEEDINGS |
|---|---|

On June 27, 2014, we instituted settled administrative proceedings against Respondents, pursuant to which they agreed to wind down their businesses as registered investment advisers and to distribute certain "side pocket" investments by December 31, 2015.[1] Two of the Respondents—S.A.C. Capital Advisors, L.P. ("SAC LP") and 72 Credit Management, LLC ("72 Credit" and, with SAC LP, "Applicants")—now seek a one-year extension of that deadline because of claimed difficulties distributing the side pocket investments. The order instituting these settled proceedings contemplated that Applicants could ask for such an extension, and neither the Division of Enforcement nor the Division of Investment Management has opposed Applicants' motion to amend the order instituting proceedings to extend the deadline. For the reasons discussed below, we find that an amendment is appropriate and grant the motion.

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1 *S.A.C. Capital Advisors, L.P.*, Investment Adviser Act Release No. 3864, 2014 WL 2915930, at * 4 (June 27, 2014).

## I. Background

On November 8, 2013, SAC LP and three related entities pleaded guilty in U.S. district court to one count of wire fraud in violation of 18 U.S.C. § 1343, and one count of securities fraud in violation of 15 U.S.C. §§ 78j(b) and 78ff and 17 C.F.R. §§ 240.10b-5 and 240.10b5-2.[2] The criminal charges were based, in part, on allegations that multiple employees and agents of the four entities, over the course of several years, obtained material, nonpublic information relating to publicly traded companies and executed, or caused the funds managed by those entities to execute, securities trades based on that information.

On June 27, 2014, we instituted settled administrative proceedings against the four entities that pleaded guilty to the criminal charges and six other related entities, including 72 Credit. As part of the settled proceedings, Applicants agreed to complete certain undertakings, including that they would distribute certain "side pocket investments, proceeds therefrom or ownership interests in an entity holding all or a portion of such investments" to a "family office" managed by Steven A. Cohen, the founder and owner of SAC LP, by December 31, 2015. Applicants further agreed that they would cease being investment advisers as defined under Section 202(a)(11) of the Advisers Act by the same date.[3] The order instituting proceedings additionally provided that, "in order to allow [Applicants] to complete an orderly winddown of their business as registered investment advisers," they may "apply to the Commission to extend the date by which they must distribute the side pocket investments . . . ."

## II. Applicants' Motion

Applicants now move for an extension of the date by which they must distribute the side pocket investments. Applicants represent that Respondents have completed four of the eight required undertakings and are in compliance with the others. But Applicants claim that, despite "their best efforts," they do not expect to be able to complete an orderly winddown of their business as registered investment advisers by December 31, 2015. Applicants explain that they have encountered difficulties in distributing the side pocket investments, including that they do not directly control the liquidation process and that alternate means of distributing the assets would reduce the amount realized by side pocket investors, many of whom are third parties.

Applicants contend "that an extension until December 31, 2016 should allow enough time to dispose of a substantial portion of the investments in a manner that is in the best interest of investors." They add that they "will undertake to update the Commission staff on a quarterly basis regarding the liquidation of the remaining side pocket investments" and that "management

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2 *SEC v. CR Intrinsic Investors, LLC, et al.*, 12-CV-8466 (VM) (S.D.N.Y.); *SEC v. Sigma Capital Mgmt., LLC, et al.*, 13-CV¬1740 (HB) (S.D.N.Y.).

3 17 C.F.R. § 275.202(a)(11).

of these side pocket investments will remain the sole purpose for which the Applicants are permitted to operate as investment advisers." Applicants therefore request that the Commission "extend the date by which they must distribute the side pocket investments, proceeds therefrom or ownership interests in an entity holding all or a portion of such investments and cease to be 'investment advisers' from December 31, 2015 to December 31, 2016." Neither the Division of Enforcement nor the Division of Investment Management has opposed Applicants' motion.

## III. Analysis

Under Rule of Practice 200(d)(1), the Commission may, at any time, upon a motion by a party, amend an order instituting proceedings to include new matters of fact or law.[4] And the order instituting proceedings in this matter expressly contemplates that Applicants may apply to the Commission for an extension by which they must distribute the side pocket investments in order to complete an orderly winddown of their business as registered investment advisers. Based on Applicants' representations about difficulties in distributing those assets, their representations that the additional time will allow them to distribute those assets in a way that benefits third-party investors, and the fact that the Divisions of Enforcement and Investment Management have not objected, we believe that granting the requested relief is appropriate.

Accordingly, IT IS ORDERED that Applicants' motion to amend the order instituting proceedings is granted; and it is further

ORDERED that the date on the first line of paragraph 15, subsection e, be amended to read "before December 31, 2016"; and it is further

ORDERED that the date on the first line of paragraph 15, subsection f, be amended to read "before December 31, 2016"; and it is further

ORDERED that paragraph 15, subsection g, be amended to add that Respondents are also required "to update Sanjay Wadhwa, Senior Associate Regional Director (New York Regional Office), as to the status of any remaining side pocket investments each calendar quarter beginning with the first quarter of 2016"; and it is further

ORDERED that the date on the last line of paragraph 15, subsection h, be amended to read "no later than February 28, 2017"; and it is further

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4 17 C.F.R. § 201.200(d)(1).

ORDERED that Section IV.(A) be amended in its entirety to read "Effective December 31, 2016, the registration of Respondent SAC LP as an investment adviser is revoked."

By the Commission.

Brent J. Fields
Secretary

Lynn M. Powalski

By: Lynn M. Powalski
Deputy Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-76548; File No. SR-OCC-2015-804)

December 3, 2015

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of No Objection to Advance Notice Filing to Modify The Options Clearing Corporation's Margin Methodology by Incorporating Variations in Implied Volatility

On October 5, 2015, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") the advance notice SR-OCC-2015-804 pursuant to Section 806(e)(1) of the Payment, Clearing, and Settlement Supervision Act of 2010 ("Payment, Clearing and Settlement Supervision Act")[1] and Rule 19b-4(n)(1)(i) under the Securities Exchange Act of 1934 (" Exchange Act").[2] The advance notice was published for comment in the Federal Register on November 17, 2015.[3] The Commission did not receive any comments on the advance notice publication. This publication serves as a notice that the Commission does not object to the changes set forth in the advance notice.

1 12 U.S.C. 5465(e)(1). The Financial Stability Oversight Council designated OCC a systemically important financial market utility on July 18, 2012. *See* Financial Stability Oversight Council 2012 Annual Report, Appendix A, http://www.treasury.gov/initiatives/fsoc/Documents/2012%20Annual%20Report.pdf. Therefore, OCC is required to comply with the Payment, Clearing, and Settlement Supervision Act and file advance notices with the Commission. *See* 12 U.S.C. 5465(e).

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

3 Securities Exchange Act Release No. 76421 (November 10, 2015), 80 FR 71900 (November 17, 2015) (SR-OCC-2015-804). OCC also filed a proposed rule change with the Commission pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4 thereunder, seeking approval of changes to its rules necessary to implement the proposal. 15 U.S.C. 78s(b)(1) and 17 CFR 240.19b-4, respectively. *See* Exchange Act Release 76128 (October 13, 2015), 80 FR 63264 (October 19, 2015) (SR-OCC-2015-016). The Commission did not receive any comments on the proposed rule change.

I. Description of the Advance Notice

According to OCC, it is modifying its margin methodology by more broadly incorporating variations in implied volatility within OCC's System for Theoretical Analysis and Numerical Simulations ("STANS").[4] As explained below, OCC believes that expanding the use of variations in implied volatility within STANS for substantially all[5] option contracts available to be cleared by OCC that have a residual tenor[6] of less than three years ("Shorter Tenor Options") will enhance OCC's ability to ensure that option prices and the margin coverage related to such positions more appropriately reflect possible future market value fluctuations and better protect OCC in the event it must liquidate the portfolio of a suspended clearing member.

*Implied Volatility in STANS Generally*

According to OCC, STANS is OCC's proprietary risk management system that calculates clearing members' margin requirements. According to OCC, the STANS methodology uses Monte Carlo simulations to forecast price movement and correlations in determining a clearing member's margin requirement. According to OCC, under

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4 This proposal did not propose any changes concerning futures. According to OCC, OCC uses a different system to calculate initial margin requirements for segregated futures accounts: Standard Portfolio Analysis of Risk Margin Calculation System.

5 According to OCC, it proposes to exclude: (i) binary options, (ii) options on energy futures, and (iii) options on U.S. Treasury securities. OCC excluded them because: (i) they are new products that were introduced as OCC was completing this proposal and (ii) OCC did not believe that there was substantive risk if they were excluded at this time because they only represent a *de minimis* open interest. According to OCC, it plans to modify its margin methodology to accommodate these new products.

6 According to OCC, the "tenor" of an option is the amount of time remaining to its expiration.

STANS, the daily margin calculation for each clearing member account is constructed to ensure OCC maintains sufficient financial resources to liquidate a defaulting member's positions, without loss, within the liquidation horizon of two business days.

As described by OCC, the STANS margin requirement for an account is composed of two primary components: a base component and a stress test component. According to OCC, the base component is obtained from a risk measure of the expected margin shortfall for an account that results under Monte Carlo price movement simulations. For the exposures that are observed regarding the account, the base component is established as the estimated average of potential losses higher than the 99% VaR[7] threshold. In addition, OCC augments the base component using the stress test component. According to OCC, the stress test component is obtained by considering increases in the expected margin shortfall for an account that would occur due to: (i) market movements that are especially large and/or in which certain risk factors would exhibit perfect or zero correlations rather than correlations otherwise estimated using historical data or (ii) extreme and adverse idiosyncratic movements for individual risk factors to which the account is particularly exposed.

According to OCC, including variations in implied volatility within STANS is intended to ensure that the anticipated cost of liquidating each Shorter Tenor Option position in an account recognizes the possibility that implied volatility could change during the two business day liquidation time horizon in STANS and lead to corresponding changes in the market prices of the options. According to OCC, generally

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7 The term "value at risk" or "VaR" refers to a statistical technique that, generally speaking, is used in risk management to measure the potential risk of loss for a given set of assets over a particular time horizon.

speaking, the implied volatility of an option is a measure of the expected future volatility of the value of the option's annualized standard deviation of the price of the underlying security, index, or future at exercise, which is reflected in the current option premium in the market. Using the Black-Scholes options pricing model, the implied volatility is the standard deviation of the underlying asset price necessary to arrive at the market price of an option of a given strike, time to maturity, underlying asset price and given the current risk-free rate. In effect, the implied volatility is responsible for that portion of the premium that cannot be explained by the then-current intrinsic value[8] of the option, discounted to reflect its time value. According to OCC, it currently incorporates variations in implied volatility as risk factors for certain options with residual tenors of at least three years ("Longer Tenor Options").

*Implied Volatility for Shorter Tenor Options*

OCC is proposing certain modifications to STANS to more broadly incorporate variations in implied volatility for Shorter Tenor Options. Consistent with its approach for Longer Tenor Options, OCC will model a volatility surface[9] for Shorter Tenor Options by incorporating into the econometric models underlying STANS certain risk factors regarding a time series of proportional changes in implied volatilities for a range of tenors and absolute deltas. Shorter Tenor Option volatility points will be defined by

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8 According to OCC, generally speaking, the intrinsic value is the difference between the price of the underlying and the exercise price of the option.

9 According to OCC, the term "volatility surface" refers to a three-dimensional graphed surface that represents the implied volatility for possible tenors of the option and the implied volatility of the option over those tenors for the possible levels of "moneyness" of the option. According to OCC, the term "moneyness" refers to the relationship between the current market price of the underlying interest and the exercise price.

three different tenors and three different absolute deltas, which produce nine "pivot points." In calculating the implied volatility values for each pivot point, OCC will use the same type of series-level pricing data set to create the nine pivot points that it uses to create the pivot points used for Longer Tenor Options, so that the nine pivot points will be the result of a consolidation of the entire series-level dataset into a smaller and more manageable set of pivot points before modeling the volatility surface.

According to OCC, it considered incorporating more than nine pivot points but concluded that would not be appropriate for Shorter Tenor Options because: (i) back-testing results, from January 2008 to May 2013, revealed that using more pivot points did not produce more meaningful information (i.e. more pivot points produced a comparable number of under-margined instances) and (ii) given the large volume of Shorter Tenor Options, using more pivot points could increase computation time and, therefore, would impair OCC from making timely calculations.

Under OCC's model for Shorter Tenor Options, the volatility surfaces will be defined using tenors of one month, three months, and one year with absolute deltas, in each case, of 0.25, 0.5, and 0.75,[10] thus resulting in the nine implied volatility pivot points. OCC believes that it is appropriate to focus on pivot points representing at- and near-the-money options because prices for those options are more sensitive to variations in implied volatility over the liquidation time horizon of two business days. According to OCC, four factors explain 99% variance of implied volatility movements: (i) a parallel

10 According to OCC, given that premiums of deep-in-the-money options (those with absolute deltas closer to 1.0) and deep-out-of-the-money options (those with absolute deltas closer to 0) are insensitive to changes in implied volatility, in each case notwithstanding increases or decreases in implied volatility over the two business day liquidation time horizon, those higher and lower absolute deltas have not been selected as pivot points.

shift of the entire surface; (ii) a slope or skewness with respect to delta; (iii) a slope with respect to time to maturity; and (iv) a convexity with respect to the time to maturity. According to OCC, the nine correlated pivot points, arranged by delta and tenor, give OCC the flexibility to capture these factors.

According to OCC, it first will use its econometric models to jointly simulate changes to implied volatility at the nine pivot points and changes to underlying prices.[11] For each Shorter Tenor Option in the account of a clearing member, changes in its implied volatility then will be simulated according to the corresponding pivot point and the price of the option will be computed to determine the amount of profit or loss in the account under the particular STANS price simulation. Additionally, as OCC does today, it will continue to use simulated closing prices for the assets underlying options in the account of a clearing member that are scheduled to expire within the liquidation time horizon of two business days to compute the options' intrinsic value and use those values to help calculate the profit or loss in the account.[12]

*Effects of the Proposed Change and Implementation*

OCC believes that the proposed change will enhance OCC's ability to ensure that STANS appropriately takes into account normal market conditions that OCC may encounter in the event that, pursuant to OCC Rule 1102, it suspends a defaulted clearing

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11 According to OCC, STANS relies on 10,000 price simulation scenarios that are based generally on a historical data period of 500 business days, which is updated monthly to keep model results from becoming stale.

12 For such Shorter Tenor Options that are scheduled to expire on the open of the market rather than the close, OCC will use the relevant opening price for the underlying assets.

member and liquidates its accounts.[13] Accordingly, OCC believes that the change will promote OCC's ability to ensure that margin assets are sufficient to liquidate the accounts of a defaulted clearing member without incurring a loss.

OCC estimates that this change generally will increase margin requirements overall, but will decrease margin requirements for certain accounts with certain positions. Specifically, OCC expects this change to increase aggregate margins by about 9% ($1.5 billion). OCC also estimates the change will most significantly affect customer accounts and least significantly affect firm accounts, with the effect on market maker accounts falling in between.

According to OCC, it expects customer accounts to experience the largest margin increases because positions considered under STANS for customer accounts typically consist of more short than long options positions, and therefore reflect a greater magnitude of directional risk than other account types. According to OCC, positions considered under STANS for customer accounts typically consist of more short than long options positions to facilitate clearing members' compliance with Commission requirements for the protection of certain customer property under Exchange Act Rule 15c3-3(b).[14] Therefore, OCC segregates the long option positions in the customer

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13 According to OCC, under authority in OCC Rules 1104 and 1106, OCC has authority to promptly liquidate margin assets and options positions of a suspended clearing member in the most orderly manner practicable, which might include, but would not be limited to, a private auction.

14 17 CFR 240.15c3-3(b).

accounts of each clearing member and does not assign the long option positions any value when determining the margin for the customer account, resulting in higher margin.[15]

OCC expects margin requirements to decrease for accounts with underlying exposure and implied volatility exposure in the same direction, such as concentrated call positions, due to the negative correlation typically observed between these two factors. According to OCC, over the back-testing period, about 28% of the observations for accounts on the days studied had lower margins under the proposed methodology and the average reduction was about 2.7%. Parallel results will be made available to the membership in the weeks ahead of implementation.

To help clearing members prepare for the proposed change, OCC has provided clearing members with an information memorandum explaining the proposal, including the planned timeline for its implementation, and discussed with certain other clearinghouses the likely effects of the change on OCC's cross-margin agreements with them. OCC also published an information memorandum to notify clearing members of the submission of this filing to the Commission. Subject to all necessary regulatory approvals regarding the proposed change, OCC intends to begin making parallel margin calculations with and without the changes in the margin methodology. The commencement of the calculations will be announced by an information memorandum, and OCC will provide the calculations to clearing members each business day. OCC also

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15 *See* OCC Rule 601(d)(1). According to OCC, pursuant to OCC Rule 611, however, a clearing member, subject to certain conditions, may instruct OCC to release segregated long option positions from segregation. Long positions may be released, for example, if they are part of a spread position. Once released from segregation, OCC receives a lien on each unsegregated long securities option carried in a customers' account and therefore OCC permits the unsegregated long to offset corresponding short option positions in the account.

will provide at least thirty days prior notice to clearing members before implementing the change. OCC believes that clearing members will have sufficient time and data to plan for the potential increases in their respective margin requirements.

## II. Discussion and Commission Findings

Although the Payment, Clearing and Settlement Supervision Act does not specify a standard of review for an advance notice, its stated purpose is instructive.[16] The stated purpose is to mitigate systemic risk in the financial system and promote financial stability by, among other things, promoting uniform risk management standards for systemically important financial market utilities and strengthening the liquidity of systemically important financial market utilities.[17] Section 805(a)(2) of the Payment, Clearing and Settlement Supervision Act[18] authorizes the Commission to prescribe risk management standards for the payment, clearing, and settlement activities of designated clearing entities and financial institutions engaged in designated activities for which it is the Supervisory Agency or the appropriate financial regulator. Section 805(b) of the Payment, Clearing and Settlement Supervision Act[19] states that the objectives and principles for the risk management standards prescribed under Section 805(a) shall be to:

- promote robust risk management;
- promote safety and soundness;
- reduce systemic risks; and

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16 *See* 12 U.S.C. 5461(b).

17 *Id.*

18 12 U.S.C. 5464(a)(2).

19 12 U.S.C. 5464(b).

- support the stability of the broader financial system.

The Commission has adopted risk management standards under Section 805(a)(2) of the Payment, Clearing and Settlement Supervision Act[20] and the Exchange Act ("Clearing Agency Standards").[21] The Clearing Agency Standards require registered clearing agencies to establish, implement, maintain, and enforce written policies and procedures that are reasonably designed to meet certain minimum requirements for their operations and risk management practices on an ongoing basis.[22] Therefore, it is appropriate for the Commission to review advance notices against these Clearing Agency Standards and the objectives and principles of these risk management standards as described in Section 805(b) of the Payment, Clearing and Settlement Supervision Act.[23]

The Commission believes that the proposal in the advance notice is consistent with the Clearing Agency Standards, in particular, Rule 17Ad-22(b)(2) under the Exchange Act.[24] Rule 17Ad-22(b)(2) under the Exchange Act[25] requires OCC to establish, implement, maintain and enforce written policies and procedures reasonably designed to use margin requirements to limit its credit exposures to participants under normal market conditions and use risk-based models and parameters to set margin

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20 12 U.S.C. 5464(a)(2).

21 *See* 17 CFR 240.17Ad-22. Securities Exchange Act Release No. 68080 (October 22, 2012), 77 FR 66220 (November 2, 2012) (S7-08-11).

22 *Id.*

23 12 U.S.C. 5464(b).

24 17 CFR 240.17Ad-22(b)(2).

25 *Id.*

requirements, among other things. Through this proposal, OCC is modifying its margin methodology, which is designed to use margin requirements to limit its credit exposures to clearing members holding Shorter Tenor Options under normal market conditions. Specifically, OCC is modifying its risk-based model, STANS, to set margin requirements in a way that includes changes in implied volatility for Shorter Tenor Options. With this change in place, STANS is now designed to recognize a range of possible changes in implied volatility during the two business day liquidation time horizon that could lead to corresponding changes in the market prices of Shorter Tenor Options. Therefore, OCC's change is consistent with Rule 17Ad-22(b)(2) under the Exchange Act.[26]

The Commission believes that OCC's proposal is consistent with the objectives and principles described in Section 805(b) of the Payment, Clearing and Settlement Supervision Act,[27] including that it is consistent with promoting robust risk management and promoting safety and soundness. The Commission believes that the proposal is consistent with promoting risk management because, with this change, STANS is now designed to recognize the possibility that implied volatility could change during the two business day liquidation time horizon and lead to corresponding changes in the market prices of the options. This change to STANS is consistent with promoting robust risk management because it is designed so that OCC now will be less likely to face operational disruption in the event of a participant default.

This change also is consistent with promoting safety and soundness of OCC. As a result of this proposal, STANS is now designed to recognize a range of possible changes

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26 *Id.*

27 12 U.S.C. 5464(b).

in implied volatility during the two business day liquidation time horizon that could lead to corresponding changes in the market prices of Shorter Tenor Options. This change is designed to enable OCC to more accurately calculate the amount of margin a member must post, and, therefore, make it less likely, in the event of a member default, that OCC will need to access mutualized clearing fund deposits to cover losses associated with such member's default, which is consistent with promoting safety and soundness.

For these reasons, the Commission does not object to the advance notice.

III. Conclusion

IT IS THEREFORE NOTICED, pursuant to Section 806(e)(1)(I) of the Payment, Clearing and Settlement Supervision Act,[28] that the Commission DOES NOT OBJECT to the proposed change, and AUTHORIZES OCC to implement the change in this advance notice (SR-OCC-2015-804) as of the date of this notice or the date of an order by the Commission approving a proposed rule change that reflects rule changes that are consistent with this advance notice (SR-OCC-2015-016), whichever is later.

By the Commission.

Robert W. Errett
Deputy Secretary

[28] 12 U.S.C. 5465(e)(1)(I).

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 76558 / December 4, 2015

Admin. Proc. File No. 3-16461

In the Matter of the Application of

KEILEN DIMONE WILEY

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY PROCEEDINGS

**Conversion of firm funds**

Associated person of member firm of registered securities association converted insurance premium payments and provided false and misleading information to self-regulatory organization during an on-the-record interview. *Held*, association's findings of violation and imposition of sanctions are sustained.

APPEARANCES:

*Dawn R. Meade* and *Ashley M. Spencer*, of the Spencer Law Firm, for Keilen Dimone Wiley.

*Alan Lawhead* and *Lisa Jones Toms* for FINRA.

Appeal filed: March 26, 2015
Last brief received: July 23, 2015

Keilen Dimone Wiley, who was formerly associated with Farmers Financial, LLC, a FINRA member, seeks review of a FINRA disciplinary action. Wiley intentionally used customer insurance premiums to pay personal and business expenses. At issue here is whether this conduct violates FINRA Rule 2010, which requires that FINRA members and associated

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persons observe high standards of commercial honor and just and equitable principles of trade.[1] We find that it does because it shows that Wiley is unable to fulfill the basic duties of a securities professional, which include being entrusted to handle customer funds. We sustain FINRA's finding of violation and the bar from association with any FINRA member firm based on our independent review of the record. We also sustain FINRA's finding that Wiley gave false and misleading testimony about his use of customer insurance premiums in violation of FINRA Rules 8210 and 2010.

## I. Background

### A. Wiley sold Farmers Insurance products while associated with a FINRA member firm.

From April 2002 to July 2011, Wiley was associated with Farmers Financial, LLC, a FINRA member firm. He held two securities licenses as an Investment Company Products/Variable Contracts Limited Representative (Series 6) and a Uniform Securities Agent (Series 63). During this time, Wiley also was an independent insurance agent in the State of Texas with Farmers Insurance, an affiliate of Farmers Financial.

Wiley sold insurance products. As set forth in his Agent Appointment Agreement with Farmers Insurance, Wiley agreed to "sell insurance for the Companies and to submit to the Companies every request or application for insurance for the classes and lines underwritten by the Companies and eligible in accordance with their published Rules and Manuals." He also agreed to collect and promptly remit monies paid by policyholders that were due to Farmers and to conform to "normal good business practices" and to all applicable state and federal laws governing his conduct.

Wiley sold Farmers Insurance products under a "doing business as" designation of Wiley Insurance Agency and Associates ("WIA"). He had two bank accounts in the name of WIA. One account he used for business and personal expenditures and the other was a merchant banking account for insurance premiums that customers paid with credit cards.

Farmers Insurance had internal policies and procedures that set forth the method for all of its insurance agents to collect and deposit customer insurance premium payments. A Famers Insurance senior auditor testified that Farmers Insurance required its agents to report the receipt of customer payments in the Agent's Credit Advice or "ACA" system. Farmers Insurance established "co-banking" accounts at various banks nationwide for its agents to deposit collected insurance premium payments. The Farmers ACA Manual and the Farmers Agency Operations Guide stressed the importance of making timely deposits in the co-banking account. Specifically, Farmers required agents to deposit customer funds within twenty-four hours of

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[1] Although Rule 2010 applies to FINRA members, FINRA Rule 0140(a) provides that "[p]ersons associated with a member shall have the same duties and obligations as a member under the Rules."

receipt. The ACA Manual also warned against commingling customer funds and cautioned that it could trigger internal audits and "lead to disciplinary action, up to and including termination of the agency agreement."

**B. Wiley used customer insurance premium payments for personal and business expenses.**

Beginning in March 2011, and through May 2011, Wiley collected $7,703.06 in Farmers Insurance premium payments from fifty-four different customers. Wiley reported the receipt of these payments in the ACA system. But instead of promptly depositing the funds with Farmers Insurance, Wiley deposited $6,532.70 of the amount he collected into his WIA business bank account. He then used these funds for personal and business expenses.

After several weeks, a Farmers Insurance internal audit team discovered the deposits missing from Wiley's co-banking account. The Farmers Insurance senior auditor conducted an internal investigation, which included a review of Wiley's ACA system reports, his deposits into the co-banking account, and an interview with Wiley.

Before the audit interview, Wiley's performance manager informed Wiley of the missing deposits. Wiley then made deposits into his co-banking account to replace most of the missing deposits. On May 2, 2011, Wiley deposited a WIA check for $1,690.64; on May 6, 2011, he deposited another WIA check for $1,954.52; and on May 9, 2011, he deposited $2,250.94 in cash. On May 11, 2011, the day of the audit interview, Wiley handed the senior auditor the remaining outstanding balance of $637.70 in cash and money orders.

During his interview, Wiley admitted to his performance manager and the senior auditor that it was his practice to deposit customer payments he received for insurance premiums into his WIA business account instead of the Farmers Insurance co-banking account. The senior auditor testified that Wiley stated that he deposited customer payments into his WIA business account because he needed to use the money "for a little while." Wiley admitted that he used the funds he received from customers to pay for his own personal and business expenses.

Wiley signed a written statement at the end of his interview in which he made the following admissions:

> I made it a practice of depositing cash collections into my [WIA and Associates] business account . . . and then writing a check to Farmers. . . . As time went on, I needed funds for the WIA and Associates bank account and delayed depositing the insureds' cash collections to the company co-banking account by a month or more. . . While customer collections did end up being used to pay for my personal and business expenses, this was not my intent.

The next business day, Wiley voluntarily provided an additional statement to his performance manager by email. Wiley explained the array of financial problems he had faced that he asserted contributed to his use of the customer payments and his delay in depositing them in the co-banking account, including: a bitter divorce, a foreclosure on his home, staffing problems, his poor credit, and negative balances in his bank accounts. He admitted that using customer payments and repaying Farmers Insurance later "was questionable [to] say the least." He also stated, "I [knew] that would be walking a fine line. It was a risk I was willing to take. Why? Because I had to keep the business going."

Farmers Financial terminated Wiley on June 7, 2011 and subsequently filed a Uniform Termination Notice for Securities Industry Registration ("Form U5") reporting his termination.

**C. FINRA investigated Wiley's misuse of customer funds.**

FINRA's Department of Enforcement subsequently began an investigation. As part of the investigation, Wiley was required, pursuant to FINRA Rule 8210, to provide sworn on-the-record testimony ("OTR"). During his OTR, Wiley confirmed that he understood FINRA Rule 8210's requirement that he answer questions fully, accurately, and truthfully. When FINRA staff asked him whether he used customer funds for his personal use, Wiley answered "No." Then he stated that he had disagreed with his original statement when he signed it. He suggested that his previous admissions of using the customer insurance premiums had been misinterpreted because in looking at all of his bank accounts, "the money was always there from the customers' payments that we collected."

**D. FINRA found that Wiley violated FINRA Rules as charged and imposed sanctions.**

FINRA Enforcement filed a two-cause complaint in 2013 alleging that Wiley intentionally converted customer insurance premium payments for his own use in violation of FINRA Rule 2010 and provided false and misleading testimony to FINRA during his OTR when he denied using the customer payments for personal and business expenses in violation of FINRA Rules 8210 and 2010. In his answer to the complaint, Wiley admitted that he was subject to FINRA's jurisdiction for purposes of this proceeding because the complaint charged Wiley with misconduct that he committed while registered or associated with a FINRA member.

On April 29, 2014, a FINRA hearing panel found that, from March through April 2011, Wiley converted the insurance premium payments he received from fifty-four customers in violation of FINRA rules. Specifically, the hearing panel found credible testimony from the senior auditor that Wiley voluntarily signed a statement admitting to using the customer premiums for business and personal use. The hearing panel found that Wiley's email to his performance manager the next business day after the audit interview, which elaborated on his earlier admissions, corroborated the senior auditor's testimony. The hearing panel also rejected Wiley's claims that he testified truthfully at his sworn OTR.

One panelist dissented from the hearing panel majority's findings of violation and sanction. The panelist found that "the premiums belonged to WIA and WIA owed a debt to Farmers for the premiums Wiley collected." The panelist gave no weight to Wiley's written statement, finding that Wiley signed the statement under duress.

On appeal, FINRA's National Adjudicatory Counsel ("NAC") affirmed the Hearing Panel's findings and sanctions it imposed. The NAC barred Wiley from association with any FINRA member firm in any capacity for his conversion violation and found that his sanction appropriately fell within the FINRA Sanction Guidelines. In light of this bar, the NAC declined to impose a sanction for providing false testimony. This appeal followed.

## II. Analysis

### A. Standard of Review

We base our findings on an independent review of the record and apply the preponderance of the evidence standard for self-regulatory organization ("SRO") disciplinary actions.[2] Pursuant to Exchange Act Section 19(e)(1), in reviewing an SRO disciplinary action, we determine whether the aggrieved person engaged in the conduct found by the SRO, whether such conduct violates the SRO's rules, and whether such SRO rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.[3]

### B. FINRA has jurisdiction over Wiley.

We find that FINRA has jurisdiction over Wiley to determine whether, in the conduct of his business, he has observed high standards of commercial honor and just and equitable principles of trade. It is undisputed that, during the relevant period, Wiley was registered as an investment company products and variable contracts representative and was associated with Farmers Financial, a FINRA member firm. As a registered person and a person associated with a member firm, Wiley's business-related conduct is subject to discipline in accordance with FINRA rules.

We have repeatedly held that FINRA's disciplinary authority is broad enough to encompass business-related conduct that is inconsistent with just and equitable principles of trade, even if that activity does not involve a security.[4] And as early as 1975, the Commission upheld disciplinary action against a person associated with a member firm for misconduct related

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2 *See David M. Levine*, Exchange Act Release No. 48760, 2003 WL 22570694, at *2, *9 n.42 (Nov. 7, 2003).

3 15 U.S.C. § 78s(e)(1).

4 *Daniel D. Manoff,* Exchange Act Release No. 46708, 2002 WL 31769236, at *4 (Oct. 23, 2002) (finding workplace conduct inconsistent with just and equitable principles of trade and high standards of commercial honor when respondent charged expenses to a co-worker's credit card without authorization); *James A. Goetz,* Exchange Act Release No. 39796, 1998 WL 130849, at *4 (March 25, 1998) (finding conduct inconsistent with just and equitable principles of trade when respondent knowingly received money from his firm's matching gift program for donations that he did not make).

to the sale of insurance products, even though that misconduct did not involve securities.[5] Thus, Wiley's unethical business-related conduct, even while performing insurance-related activities, falls under FINRA's jurisdiction.

Wiley contends that FINRA's jurisdiction is limited to the securities industry and that it improperly "ventured into the distinctly separate and different realms of insurance and Texas independent contractor and contract law." He argues that only the states can regulate the insurance industry and resolve disputes that involve independent contractors or contract law. But state laws governing insurance business practices and independent contractors are irrelevant in this case because FINRA brought this disciplinary action against Wiley for violating FINRA rules. As an associated person of a FINRA member firm, Wiley was subject to FINRA's prohibition on converting customer premium payments for his own use.

Wiley unsuccessfully attempts to distinguish the long line of Commission cases holding that FINRA's disciplinary authority is broad enough to encompass business-related conduct that does not involve securities if that conduct is inconsistent with just and equitable principles of trade. He claims that none of those cases involved an independent contract insurance agent who never participated in the securities industry. And he claims that, unlike respondents in prior cases, he never fraudulently misappropriated insurance premiums, falsified documents, or allowed policies to lapse. But Wiley's status as an independent contractor does not shield him from complying with FINRA rules. FINRA Rule 2010 "protects investors and the securities industry from dishonest practices that are unfair to investors or hinder the functioning of a free and open market, even though those practices may not be illegal or violate a specific rule or regulation."[6]

Although Wiley cites *Samuel B. Franklin*[7] for the proposition that the Commission has held that neither it nor FINRA has the authority to decide private contract rights, it is Wiley's violation of FINRA Rule 2010, not his violation of any contract, that is at issue here. Further, in *Franklin*, we noted that breaching a contract could violate FINRA Rule 2010 if the "member's failure to live up to contractual obligations . . . would constitute dishonorable and inequitable conduct not consistent with 'just and equitable principles of trade.'"[8]

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5 *Thomas E. Jackson*, Exchange Act Release No. 11476, 1975 WL 162936, at *2 (June 16, 1975) (holding that applicant's forging signature on insurance policies contravened standards of commercial honor and that, although his wrongdoing did not involve securities, on another occasion it might).

6 *Steven R. Tomlinson,* Exchange Act Release No. 73825, 2014 WL 6985131, at *5 n.15 (Dec. 11, 2014); *Benjamin Werner*, Exchange Act Release No. 9242,1971 WL 120499, at *2 (July 9, 1971) (upholding penalties against respondent for conduct inconsistent with just and equitable principles of trade even though such conduct was not held to be unlawful).

7 Exchange Act Release No. 5603, 1957 WL 52433 (Nov. 18, 1957).

8 *Id.* at *3 (internal quotations omitted).

Wiley argues that provisions of FINRA's arbitration code and related arbitration cases support his claim that FINRA lacks jurisdiction here. But this disciplinary proceeding is governed by FINRA's Code of Procedure, not its Code of Arbitration Procedure, so Wiley's reliance on arbitration provisions and cases is misplaced. Nor do we need to engage in a comprehensive review of Wiley's insurance business and apply Texas independent contractor law to determine whether his conduct is inconsistent with just and equitable principles of trade.

### C. Wiley's conversion of customer insurance premium payments violated FINRA Rule 2010.

Rule 2010 requires that FINRA members and associated persons "observe high standards of commercial honor and just and equitable principles of trade." The Rule prohibits misconduct that "reflects on the associated person's ability to comply with the regulatory requirements of the securities business and to fulfill his fiduciary duties in handling other people's money."[9] Conversion is defined under FINRA's Sanction Guidelines as the "intentional and unauthorized taking of and/or exercise of ownership over property by one who neither owns the property nor is entitled to possess it."[10] In this case, FINRA established each element of the definition of conversion in the Sanctions Guidelines and found that this conduct constituted a failure to observe high standards of commercial honor and just and equitable principles of trade in violation of FINRA Rule 2010.

The facts are undisputed that, from March through May 2011, Wiley accepted a total of $7,703.06 from fifty-four Farmers customers for the payment of their Farmers insurance premiums. But instead of forwarding the payments to Farmers to be applied to the customers' insurance policies by depositing the funds into the co-banking account, Wiley diverted $6,532.70 from those payments and deposited it into his WIA bank account. Then he used the funds to pay personal and business expenses.

We agree with FINRA that Wiley's misconduct meets the definition of conversion for the purpose of a Rule 2010 violation. Wiley's actions were intentional. He told the Farmers Insurance senior auditor that he deposited the customer payments into his WIA business bank account because he needed to use the money "for a little while." He also told the senior auditor that he used the money for business and personal expenses. He signed a written statement admitting that the "customer collections did end up being used to pay for [his] personal and business expenses." The day after signing that statement, Wiley emailed his manager explaining that he converted the customer funds because of personal troubles. He admitted his conduct was "questionable to say the least," but that it "was a risk [he] was willing to take." Wiley's written admissions demonstrate his intent to convert the customers' insurance payments for his own use, regardless of the consequences.

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9 *Manoff*, 2002 WL 31769236, at *4 (internal quotation omitted).

10 *See* FINRA Sanction Guidelines at 36 & n.2 (2013 ed.).

The record also establishes that Wiley was not authorized or entitled to use the payments for his own purposes. Farmers Insurance's ACA Manual and Agency Operations Guide stressed the importance of making timely deposits in the co-banking account, and Farmers generally required agents to make deposits of customer funds within one business day of receipt. The ACA Manual specifically prohibited commingling customer funds and warned that it could "lead to disciplinary action, up to and including termination of the agency agreement." Wiley testified that Farmers Insurance expected to receive each customer payment once it was reported in the ACA system. Wiley was not entitled to exercise ownership over the customer payments for any period of time; he was required to collect the funds on behalf of Farmers Insurance and promptly remit those payments to Farmers. Instead, Wiley admitted in a written statement that he "made it a practice" to use customer insurance premiums for his own benefit for a month or more. We find, as did FINRA, that Wiley's use of customer premium payments to pay his personal and business expenses was conversion.

Wiley contends that the Agent Appointment Agreement does not define "promptly remitting monies" due to the insurance company and that it was an error to use the Agents Guide and ACA Manual to supplement the meaning of that term. According to Wiley, he was not required to use the ACA system and co-banking program and was not bound by the terms of the ACA Manual and Agency Operations Guide. Rather, the Agent Appointment Agreement required only that he submit applications for insurance that were "eligible in accordance with the written rules and manuals." Contrary to his unsupported contention, Wiley agreed in the Agent Appointment Agreement to sell insurance in accordance with Farmers Insurance's published rules and manuals, which included the ACA Manual and Agency Operations Guide. And Wiley testified during his OTR that Famers Insurance expected agents to make entries in the ACA system and deposit customer funds in the co-banking account and that this was a common practice.

According to Wiley, "Farmers allows about a thirty day window from the date the agent enters the premiums into the ACA banking receipt system to when an agent must deposit the premiums." He argues that FINRA erred in finding that Farmers required Wiley to deposit the premiums into the co-bank account within one day of receipt. But he has produced no support for this claim. On the contrary, the Agent Appointment Agreement required Wiley to collect and promptly remit monies due to Farmers. In any event, it was Wiley's unauthorized use of the customer insurance premium payments, not his delay in depositing them into the co-banking account, that establishes conversion of customer funds.

Wiley contends that the senior auditor's testimony regarding Wiley's rights, duties, and obligations has no evidentiary value because the senior auditor does not know anything about Farmers' relationship with its independent contractors and the duties, obligations, and rights of independent contractors. But the senior auditor testified as a fact witness, not a legal expert. And his testimony is corroborated by the email Wiley sent to his performance manager. We see no reason to overturn FINRA's finding that the senior auditor testified credibly.

For the same reason, we reject the reasoning of the dissenting hearing panelist, who concluded that Wiley did not convert the premiums because "the premiums belonged to WIA and WIA owed a debt to Farmers for the premiums Wiley collected." But the dissent offers no support for this other than Wiley's testimony, which we find is outweighed by other evidence such as the Agent Appointment Agreement, the ACA Manual, the Agency Operations Guide, and the senior auditor's testimony. The dissent gave no weight to Wiley's written statement, finding that Wiley signed the statement under duress. But the dissent offered no support for this conclusion, which is inconsistent with the Hearing Panel's finding that the senior auditor testified credibly.

Wiley incorrectly contends that FINRA's findings of violation should be overturned because FINRA never defined "high standards of commercial honor and just and equitable principles of trade" and used an abbreviated version of the definition of conversion rather than the one in FINRA's Sanction Guidelines. Based on our de novo review of the record, we find, as outlined above, that FINRA established each element of the definition of conversion in the Sanctions Guidelines and that FINRA further demonstrated that Wiley's conduct constituted a failure to observe high standards of commercial honor and just and equitable principles of trade.

Although Wiley contends that FINRA presented no evidence to establish Wiley's "possessory or ownership rights" in the insurance premiums, FINRA was not required to do so. Wiley's *lack* of ownership rights in the premiums is a necessary element of a conversion claim, and that was established through the evidence discussed above.

According to Wiley, this disciplinary action rests on what is essentially a misunderstanding. Wiley asserts that he "missed a payment owed to Farmers, an internal investigation was initiated, the accounts were balanced out, and all the debt owed to Farmers was remitted and the issues between Farmers and Wiley were resolved;" that he never allowed any client policies to lapse and never failed to remit payment to Farmers; and that if he had committed any legal infractions or breached the Agent Appointment Agreement, Farmers could have taken his book of business without being required to purchase the business as Farmers ultimately did. But these assertions are beside the point. Wiley intentionally used his customers' insurance payments for personal and business expenses, knowing this conduct was "questionable." He admitted he was willing to risk his customers' premiums to keep his business operating. That he eventually paid Farmers Insurance and no policies lapsed does not change the fact that he intentionally, and without authorization, took customer premiums to which he was not entitled to pay his own expenses. We agree with FINRA that this conduct is inconsistent with just and equitable principles of trade.

**D. Wiley gave false and misleading testimony in violation of FINRA Rules 8210 and 2010.**

FINRA Rule 8210 requires associated persons to testify under oath with respect to any matter in an investigation, complaint, or proceeding.[11] Providing false or misleading information to FINRA constitutes conduct inconsistent with just and equitable principles of trade and violates FINRA Rule 2010.[12]

At an OTR on May 10, 2012, FINRA staff asked Wiley whether he used customer funds for his own personal and business expenses. Wiley, testifying under oath, recanted his earlier admissions and answered, "No." He proceeded to state that he had disagreed with his original statement when he signed it. He suggested that his previous admissions had been misinterpreted because, in looking at all of his business bank accounts, "the money was always there from the customers' payments that we collected."

But the money was not always there. During the time Wiley collected over $7,000 in customer premiums payments, his business bank accounts often reflected a negative balance. Based on this fact, FINRA rejected Wiley's claim that the customer payments were accounted for and concluded that his denial of using customer payments for his own personal and business expenses was false and misleading.

Wiley contends that he qualified his "No" response with an explanation, admitting that he used insurance premium payments for his personal and business expenses but that he thought this was permissible as long as he remitted amounts owed to Farmers within the time required to maintain insurance coverage for the customers. In short, he claims that he did not believe he was improperly using the funds to pay for personal and business expenses. But Wiley was asked whether he used the funds for his personal and business expenses, not about the propriety of doing so. His answer to that question was false and misleading.

Wiley also contends that his response to this question was not vital to FINRA's investigation and that, because FINRA found that his denial was transparently false, it did not appear to mislead anyone or impede FINRA's investigation. But the fact that his answer was blatantly misleading does not excuse his failure to comply with Rule 8210.

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11 *See* FINRA Rule 8210(a) ("FINRA staff shall have the right to . . . require a member, person associated with a member, or any other person subject to FINRA's jurisdiction to provide information orally . . . and to testify at a location specified by FINRA staff, under oath or affirmation . . . with respect to any matter involved in the investigation, complaint, examination, or proceeding . . . .").

12 *See Geoffrey Ortiz,* Exchange Act Release No. 58416, 2008 WL 3891311, at *7 (Aug. 22, 2008).

## III. Sanctions

### A. The bar FINRA imposed on Wiley is neither excessive nor oppressive and is necessary for the protection of investors.

Pursuant to Exchange Act Section 19(e)(2), we will sustain a FINRA sanction unless we find it is "excessive or oppressive" or imposes an unnecessary or inappropriate burden on competition.[13] As part of this review, we consider any aggravating or mitigating factors[14] and whether the sanctions imposed by FINRA are remedial in nature and not punitive.[15]

FINRA's Sanction Guidelines state that "a bar is standard" for conversion "regardless of [the] amount converted."[16] This approach reflects the judgment that, absent mitigating factors,[17] conversion "poses so substantial a risk to investors and/or the markets as to render the violator unfit for employment in the securities industry."[18] Indeed, conversion is antithetical to the basic requirement that customers and firms must be able to trust securities professionals with their money,[19] and one who deliberately deceives a customer and misapplies funds entrusted to him therefore demonstrates a lack of fitness to be in the securities industry.

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13 15 U.S.C. § 78s(e)(2). Wiley does not claim, and the record does not show, that FINRA's action imposed an unnecessary or inappropriate burden on competition.

14 *Saad v. SEC*, 718 F.3d 904, 906 (D.C. Cir. 2013); *PAZ Sec., Inc. v. SEC*, 494 F.3d 1059, 1064-65 (D.C. Cir. 2007).

15 *Paz Sec., Inc.*, 494 F.3d at 1065; *see also* FINRA Sanction Guidelines at 2 ("Disciplinary sanctions are remedial in nature and should be designed to deter future misconduct and to improve overall business standards in the securities industry.").

16 Guidelines at 6-7. 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). *John Joseph Plunkett,* Exchange Act Release No. 69766, 2013 WL 2898033, at *11 (June 14, 2013).

17 The Guidelines include a list of non-exhaustive aggravating and mitigating factors (*i.e.*, "Principal Considerations"), and state that, "as appropriate, Adjudicators should consider case-specific factors in addition to those listed." Guidelines, at 6-7.

18 *Charles C. Fawcett, IV*, Exchange Act Release No. 56770, 2007 WL 3306105, at *5 n.27 (Nov. 8, 2007).

19 *See John Edward Mullins*, Exchange Act Release No. 66373, 2012 WL 423413, at *18 (Feb. 10, 2012) (Conversion "is extremely serious and patently antithetical to the 'high standards of commercial honor and just and equitable principles of trade' that underpin the self-regulation of the securities markets." (internal quotation omitted)); *Joseph H. O'Brien II*, Exchange Act Release No. 34105, 1994 WL 234279, at *3 (May 25, 1994) ("In converting [customer] funds, O'Brien abused the trust that is the cornerstone of the relationship between a securities professional and his customer.").

We agree with FINRA that Wiley's intentional, unauthorized use of customer insurance premiums to pay for his personal and business expenses constitutes the type of dishonesty and self-interest that warrants a bar. That Wiley eventually remitted the premium amounts to Farmers Insurance has little if any mitigating effect because he did so only after Farmers began an investigation.[20] A bar is necessary to protect the investing public from this type of abuse of trust and confidence and to deter Wiley and others from engaging in similar misconduct in the future.

Wiley argues that FINRA erred because it "sanctioned Wiley's lawful insurance business practices which had nothing to do with the securities industry." But, as explained above, we reject Wiley's claim that FINRA lacks jurisdiction to sanction him for non-securities related conduct that is inconsistent with just and equitable principles of trade. Wiley further argues that FINRA's sanctions are a punishment for lawful behavior and that FINRA did not establish that a bar would deter future misconduct or promote the integrity of the securities industry. We agree with FINRA that Wiley's conversion of customer insurance premiums reveals a troubling disregard for one of the fundamental responsibilities of securities professionals—handling customer funds. We conclude that barring Wiley from the securities industry is neither excessive nor oppressive and is necessary to protect investors and deter him and others from engaging in similar wrongdoing.[21]

An appropriate order will issue.[22]

By the Commission (Chair WHITE and Commissioners AGUILAR, STEIN, and PIWOWAR).

Brent J. Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

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20 Guidelines, at 6 (Principal Consideration No. 4); *see, e.g., Eliezer Gurfel*, Exchange Act Release No. 41229, 1999 WL 172666, at *4 (March 30, 1999) (sustaining bar for conversion and noting that the "NASD was unimpressed by Gurfel's repayment of funds to IMMG, since Gurfel gave back the money only after he was caught, and there was no evidence suggesting Gurfel otherwise would h[a]ve repaid IMMG"), *petition denied*, 205 F.3d 400 (D.C. Cir. 2000).

21 Wiley does not challenge FINRA's order that he pay costs totaling $1,568.35, which we also sustain.

22 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. Because the issues have been thoroughly briefed and can be adequately determined on the basis of the record filed by the parties, Applicant's 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. 76558 / December 4, 2015

Admin. Proc. File No. 3-16461

In the Matter of the Application of

KEILEN DIMONE WILEY

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 by FINRA against Keilen Dimone Wiley, and the assessment of costs imposed, is sustained.

By the Commission.

Brent J. Fields
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. 76569 / December 7, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16982**

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|---|---|
| **In the Matter of**<br><br>**MICHAEL A. BANDER AND BANDER LAW FIRM, PLLC**<br><br>**Respondents.** | **ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND 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 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Michael A. Bander and Bander Law Firm, PLLC (collectively "Respondents").

## II.

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

## III.

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

**Summary**

1. Respondents violated Section 15(a)(1) of the Exchange Act by acting as unregistered broker-dealers in connection with their representation of clients who were seeking U.S. residency through the Immigrant Investor Program. Respondents, an immigration and nationality attorney and law firm, recommended that their clients participate in the Immigration Investor Program by investing in securities offered through an EB-5 Regional Center and helped effect the purchases. In addition to receiving legal fees from their clients, Respondents received a commission from the Regional Center for each investment they facilitated.

**Respondents**

2. Michael A. Bander, age 76, is a resident of Coral Gables, Florida. He is a licensed attorney concentrating in immigration and nationality law. During the relevant time period, he was a partner of Bander Law Firm PLLC.

3. Bander Law Firm, PLLC is a law firm located in Miami, Florida.

**Background**

4. The United States Congress created the Immigrant Investor Program, also known as "EB-5," in 1990 to stimulate the U.S. economy through job creation and capital investment by foreign investors. The Program offers EB-5 visas to individuals who invest $1 million in a new commercial enterprise that creates or preserves at least 10 full-time jobs for qualifying U.S. workers (or $500,000 in an enterprise located in a rural area or an area of high unemployment). A certain number of EB-5 visas are set aside for investors in approved Regional Centers. A Regional Center is defined as "any economic unit, public or private, which is involved with the promotion of economic growth, including increased export sales, improved regional productivity, job creation, and increased domestic capital investment." 8 C.F.R. § 204.6(e) (2015).

5. Typical Regional Center investment vehicles are offered as limited partnership interests. The partnership interests are securities, usually offered pursuant to one or more exemptions from the registration requirements of the U.S. securities laws. The Regional Centers are often managed by a person or entity which acts as a general partner of the limited partnership. The Regional Centers, the investment vehicles, and the managers are collectively referred to herein as "EB-5 Investment Offerers."

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

6. Various EB-5 Investment Offerers paid commissions to anyone who successfully sold limited partnership interests to new investors.

**Respondents Received Commissions for Their Clients' EB-5 Investments**

7. From at least January 2010 through February 2014, Respondents received commissions from one or more EB-5 Investment Offerers totaling $228,750. On one or more occasions, the commission was paid pursuant to an invoice for legal services sent by Respondents to the EB-5 Investment Offerers.

8. Respondents performed activities necessary to effectuate the transactions in EB-5 securities, including recommending one or more EB-5 Investment Offerers to their clients; acting as a liaison between the EB-5 Investment Offerers and the investors; and facilitating the transfer and/or documentation of investment funds to the EB-5 Investment Offerers. Respondents received transaction-based commissions for their services from the EB-5 Investment Offerers. While some of Respondents' activities overlapped with legal services, for which they received fees, Respondents were paid transaction-based compensation for the activities which effectuated the investor's transactions in EB-5 securities.

9. As a result of the conduct described above, Respondents violated Section 15(a)(1) of the Exchange Act which makes it unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer to make use of the mails or any means or instrumentality of interstate commerce "to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act.

**IV.**

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Michael A. Bander and Bander Law Firm, PLLC's Offers.

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondents shall cease and desist from committing or causing any violations and any future violations of Section 15(a)(1) of the Exchange Act.

B. Respondents shall pay, jointly and severally, disgorgement of $228,750, prejudgment interest of $19,434, and a penalty of $25,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: (1) 25% of the total amount within ten (10) days of the entry of this Order, (2) 25% of the total amount within ninety (90) days of the entry of this Order, (3) 25% of the total amount within onehundredeighty (180) days of the entry of this Order, and (4) 25% of the total amount within twohundredseventy (270) days of the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of disgorgement, prejudgment interest, and civil penalties, plus any additional interest accrued pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. § 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

(1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondents 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) Respondents 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 Michael A. Bander and Bander Law Firm, PLLC as the Respondents 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 Stephen L. Cohen, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5553.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
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. 76573 / December 7, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16986

| | |
|---|---|
| In the Matter of<br><br>MIKE S. MANESH AND<br>MANESH & MIZRAHI, APLC<br><br>Respondents. | ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND 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 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Mike S. Manesh and Manesh & Mizrahi, APLC (collectively "Respondents").

## II.

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

## III.

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

### Summary

1. Respondents violated Section 15(a)(1) of the Exchange Act by acting as unregistered broker-dealers in connection with their representation of clients who were seeking U.S. residency through the Immigrant Investor Program. Respondents, an immigration attorney and law firm, recommended that their clients participate in the Immigration Investor Program by investing in securities offered through an EB-5 Regional Center and helped effect the purchases. In addition to receiving legal fees from their clients, Respondents received a commission from the Regional Center for each investment they facilitated.

### Respondents

2. Mike S. Manesh, age 60, is a resident of Los Angeles, California. He is a licensed attorney concentrating in immigration law. During the relevant time period, he was a partner of Law Offices of Mike S. Manesh, a predecessor to Manesh & Mizrahi, APLC.

3. Manesh & Mizrahi, APLC, formerly known as Law Offices of Mike S. Manesh, is a law firm located in Los Angeles, California.

### Background

4. The United States Congress created the Immigrant Investor Program, also known as "EB-5," in 1990 to stimulate the U.S. economy through job creation and capital investment by foreign investors. The Program offers EB-5 visas to individuals who invest $1 million in a new commercial enterprise that creates or preserves at least 10 full-time jobs for qualifying U.S. workers (or $500,000 in an enterprise located in a rural area or an area of high unemployment). A certain number of EB-5 visas are set aside for investors in approved Regional Centers. A Regional Center is defined as "any economic unit, public or private, which is involved with the promotion of economic growth, including increased export sales, improved regional productivity, job creation, and increased domestic capital investment." 8 C.F.R. § 204.6(e) (2015).

5. Typical Regional Center investment vehicles are offered as limited partnership interests. The partnership interests are securities, usually offered pursuant to one or more exemptions from the registration requirements of the U.S. securities laws. The Regional Centers are often managed by a person or entity which acts as a general partner of the limited partnership. The Regional Centers, the investment vehicles, and the managers are collectively referred to herein as "EB-5 Investment Offerers."

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

6. Various EB-5 Investment Offerers paid commissions to anyone who successfully sold limited partnership interests to new investors.

**Respondents Received Commissions for Their Clients' EB-5 Investments**

7. From at least January 2010 through May 2011, Respondents received commissions from one or more EB-5 Investment Offerers totaling $85,000.

8. Respondents performed activities necessary to effectuate the transactions in EB-5 securities, including recommending one or more EB-5 Investment Offerers to their clients; acting as a liaison between the EB-5 Investment Offerers and the investors; and facilitating the transfer and/or documentation of investment funds to the EB-5 Investment Offerers. Respondents received transaction-based commissions for their services from the EB-5 Investment Offerers. While some of Respondents' activities overlapped with legal services, for which they received fees, Respondents were paid transaction-based compensation for the activities which effectuated the investor's transactions in EB-5 securities.

9. As a result of the conduct described above, Respondents violated Section 15(a)(1) of the Exchange Act which makes it unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer to make use of the mails or any means or instrumentality of interstate commerce "to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act.

**IV.**

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Mike S. Manesh and Manesh & Mizrahi, APLC's Offers.

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondents shall cease and desist from committing or causing any violations and any future violations of Section 15(a)(1) of the Exchange Act.

B. Respondents shall pay, jointly and severally, disgorgement of $85,000 and prejudgment interest of $11,159 to the Securities and Exchange Commission. Payment shall be made in the following installments: (1) 25% of the total amount within ten (10) days of the entry of this Order, (2) 25% of the total amount within ninety (90) days of the entry of this Order, (3) 25% of the total amount within one-hundred-eighty (180) days of the entry of this Order, and (4) 25% of the total amount within two-hundred-seventy (270) days of the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of disgorgement and prejudgment interest, plus any additional interest accrued pursuant to SEC Rule of Practice 600, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

(1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondents 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) Respondents 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 Mike S. Manesh and Manesh & Mizrahi, APLC as Respondents 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 Stephen L. Cohen, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5553.

## V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
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. 76572 / December 7, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16985**

**In the Matter of**

**TARANEH KHORRAMI**

**Respondent.**

**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND 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 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Taraneh Khorrami ("Respondent").

## II.

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

1. Respondent violated Section 15(a)(1) of the Exchange Act by acting as an unregistered broker-dealer in connection with her representation of clients who were seeking U.S. residency through the Immigrant Investor Program. Respondent, an immigration attorney, recommended that her clients participate in the Immigration Investor Program by investing in securities offered through an EB-5 Regional Center and helped effect the investments. In addition to receiving legal fees from her clients, Respondent received a referral fee from the Regional Center for each investment she facilitated.

### Respondent

2. Taraneh Khorrami, age 37, is a resident of Los Angeles, California. She is a licensed attorney with a focus on immigration law. During the relevant time period, she was a partner of a small Sherman Oaks, California law firm.

### Background

3. The United States Congress created the Immigrant Investor Program, also known as "EB-5," in 1990 to stimulate the U.S. economy through job creation and capital investment by foreign investors. The Program offers EB-5 visas to individuals who invest $1 million in a new commercial enterprise that creates or preserves at least 10 full-time jobs for qualifying U.S. workers (or $500,000 in an enterprise located in a rural area or an area of high unemployment). A certain number of EB-5 visas are set aside for investors in approved Regional Centers. A Regional Center is defined as "any economic unit, public or private, which is involved with the promotion of economic growth, including increased export sales, improved regional productivity, job creation, and increased domestic capital investment." 8 C.F.R. § 204.6(e) (2015).

4. Typical Regional Center investment vehicles are offered as limited partnership interests. The partnership interests are securities, usually offered pursuant to one or more exemptions from the registration requirements of the U.S. securities laws. The Regional Centers are often managed by a person or entity which acts as a general partner of the limited partnership. The Regional Centers, the investment vehicles, and the managers are collectively referred to herein as "EB-5 Investment Offerers."

5. Various EB-5 Investment Offerers paid commissions or referral fees to anyone who successfully sold limited partnership interests to new investors.

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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.

## Respondent Received Referral Fees for Her Clients' EB-5 Investments

6. From at least January 2010 through October 2011, Respondent received referral fees from one EB-5 Investment Offerer totaling $60,000. On one or more occasions, the referral fee was paid pursuant to an invoice for legal services sent by Respondent to the EB-5 Investment Offerer.

7. Respondent performed activities necessary to effectuate the transactions in EB-5 securities, including recommending one or more EB-5 Investment Offerers to her clients; acting as a liaison between the EB-5 Investment Offerers and the investors; and facilitating the transfer and/or documentation of investment funds to the EB-5 Investment Offerers. Respondent received transaction-based referral fees for her services from the EB-5 Investment Offerer. While some of Respondent's activities may have overlapped with legal services, for which she received fees, Respondent was paid transaction-based referral fees for the activities which effectuated the investor's transactions in EB-5 securities.

8. As a result of the conduct described above, Respondent violated Section 15(a)(1) of the Exchange Act which makes it unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer to make use of the mails or any means or instrumentality of interstate commerce "to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act.

## IV.

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

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 15(a)(1) of the Exchange Act.

B. Respondent shall, within ten (10) days of the entry of this Order, pay disgorgement of $60,000, prejudgment interest of $7,843, and a civil money penalty of $25,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). If timely payment of disgorgement and prejudgment interest is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 [17 C.F.R. § 201.600]. If timely payment of the civil money penalty 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 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 Taraneh Khorrami 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 Stephen L. Cohen, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5553.

**V.**

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
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. 76574 / December 7, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16987**

**In the Matter of**

**KEFEI WANG**

**Respondent.**

**ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, 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 cease-and-desist proceedings be, and hereby are, instituted pursuant to 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Kefei Wang ("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, and except as provided herein in Section V, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing 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

1. Respondent violated Section 15(a)(1) of the Exchange Act by acting as an unregistered broker-dealer in connection with his representation of clients who were seeking U.S. residency through the Immigrant Investor Program. Respondent helped effect certain individuals' securities purchases in an EB-5 Regional Center. Respondent received a commission from that Regional Center for each investment he facilitated.

### Respondent

2. Kefei Wang, age 39, is a resident of China. During the relevant time period, he was a U.S. resident and an owner of Nautilus Global Capital, LLC , a now defunct entity that was based in Fremont, California.

### Background

3. The United States Congress created the Immigrant Investor Program, also known as "EB-5," in 1990 to stimulate the U.S. economy through job creation and capital investment by foreign investors. The Program offers EB-5 visas to individuals who invest $1 million in a new commercial enterprise that creates or preserves at least 10 full-time jobs for qualifying U.S. workers (or $500,000 in an enterprise located in a rural area or an area of high unemployment). A certain number of EB-5 visas are set aside for investors in approved Regional Centers. A Regional Center is defined as "any economic unit, public or private, which is involved with the promotion of economic growth, including increased export sales, improved regional productivity, job creation, and increased domestic capital investment." 8 C.F.R. § 204.6(e) (2015).

4. Typical Regional Center investment vehicles are offered as limited partnership interests. The partnership interests are securities, usually offered pursuant to one or more exemptions from the registration requirements of the U.S. securities laws. The Regional Centers are often managed by a person or entity which acts as a general partner of the limited partnership. The Regional Centers, the investment vehicles, and the managers are collectively referred to herein as "EB-5 Investment Offerers."

5. Various EB-5 Investment Offerers paid commissions to anyone who successfully sold limited partnership interests to new investors.

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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.

**Respondent Received Commissions for His Clients' EB-5 Investments**

6. From at least January 2010 through May 2014, Respondent received a portion of commissions from one EB-5 Investment Offerer totaling $40,000. The commissions constituted his portion of the commissions that were paid pursuant to a written Agency Agreement between Nautilus Global Capital and the EB-5 Investment Offerer. On one or more occasions the commission was paid to a foreign bank account identified by the Respondent despite the fact that the Respondent was U.S.-based during the relevant time period.

7. Respondent performed activities necessary to effectuate the transaction, including recommending the specific EB-5 Investment Offerer referenced in paragraph 6 to his clients; acting as a liaison between the EB-5 Investment Offerer and the investors; and facilitating the transfer and/or documentation of investment funds to the EB-5 Investment Offerer. Respondent received his portion of transaction-based commissions due to Nautilus Global Capital for its services from that EB-5 Investment Offerer.

8. As a result of the conduct described above, Respondent violated Section 15(a)(1) of the Exchange Act which makes it unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer to make use of the mails or any means or instrumentality of interstate commerce "to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act.

## IV.

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

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 15(a)(1) of the Exchange Act.

B. Respondent shall, within ten (10) days of the entry of this Order, pay disgorgement of $40,000, prejudgment interest of $1,590, and a civil money penalty of $25,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). If timely payment of disgorgement and prejudgment interest is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 [17 C.F.R. § 201.600]. If timely payment of the civil money penalty 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 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 Kefei Wang 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 Stephen L. Cohen, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5553.

**V.**

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
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. 76568 / December 7, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16981**

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| **In the Matter of**<br><br>**MEHRON P. AZARMEHR AND AZARMEHR LAW GROUP**<br><br>**Respondents.** | **ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND 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 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Mehron P. Azarmehr and Azarmehr Law Group (collectively "Respondents").

## II.

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

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## III.

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

### Summary

1. Respondents violated Section 15(a)(1) of the Exchange Act by acting as unregistered broker-dealers in connection with their representation of clients who were seeking U.S. residency through the Immigrant Investor Program. Respondents, an immigration attorney and law firm, recommended that their clients participate in the Immigration Investor Program by investing in securities offered through an EB-5 Regional Center and helped effect the purchases. In addition to receiving legal fees from their clients, Respondents received a commission from the Regional Center for each investment they facilitated.

### Respondents

2. Mehron P. Azarmehr, age 51, is a resident of Austin, Texas. He is a licensed attorney specializing in immigration. During the relevant time period, he was a partner of Azarmehr & Associates, a predecessor to Azarmehr Law Group.

3. Azarmehr Law Group, formerly known as Azarmehr & Associates, is a law firm located in Austin, Texas.

### Background

4. The United States Congress created the Immigrant Investor Program, also known as "EB-5," in 1990 to stimulate the U.S. economy through job creation and capital investment by foreign investors. The Program offers EB-5 visas to individuals who invest $1 million in a new commercial enterprise that creates or preserves at least 10 full-time jobs for qualifying U.S. workers (or $500,000 in an enterprise located in a rural area or an area of high unemployment). A certain number of EB-5 visas are set aside for investors in approved Regional Centers. A Regional Center is defined as "any economic unit, public or private, which is involved with the promotion of economic growth, including increased export sales, improved regional productivity, job creation, and increased domestic capital investment." 8 C.F.R. § 204.6(e) (2015).

5. Typical Regional Center investment vehicles are offered as limited partnership interests. The partnership interests are securities, usually offered pursuant to one or more exemptions from the registration requirements of the U.S. securities laws. The Regional Centers are often managed by a person or entity which acts as a general partner of the limited partnership. The Regional Centers, the investment vehicles, and the managers are collectively referred to herein as "EB-5 Investment Offerers."

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

6. Various EB-5 Investment Offerers paid commissions to anyone who successfully sold limited partnership interests to new investors.

**Respondents Received Commissions for Their Clients' EB-5 Investments**

7. From at least January 2010 through December 2011, Respondents received commissions from one EB-5 Investment Offerer totaling $30,000. On one or more occasions, the commission was paid pursuant to an invoice for legal services sent by Respondents to the EB-5 Investment Offerers.

8. Respondents performed activities necessary to effectuate the transactions in EB-5 securities, including recommending one or more EB-5 Investment Offerers to their clients; acting as a liaison between the EB-5 Investment Offerers and the investors; and facilitating the transfer and/or documentation of investment funds to the EB-5 Investment Offerers. Respondents received transaction-based commissions for their services from the EB-5 Investment Offerers. While some of Respondents' activities overlapped with legal services, for which they received fees, Respondents were paid transaction-based compensation for the activities which effectuated the investor's transactions in EB-5 securities.

9. As a result of the conduct described above, Respondents violated Section 15(a)(1) of the Exchange Act which makes it unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer to make use of the mails or any means or instrumentality of interstate commerce "to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act.

**IV.**

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Mehron P. Azarmehr and Azarmehr Law Group's Offers.

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondents shall cease and desist from committing or causing any violations and any future violations of Section 15(a)(1) of the Exchange Act.

B. Respondents shall pay, jointly and severally, disgorgement of $30,000, prejudgment interest of $2,965, and a penalty of $25,000 to the Securities and Exchange Commission. Payment shall be made in the following installments: (1) 25% of the total amount within ten (10) days of the entry of this Order, (2) 25% of the total amount within ninety (90) days of the entry of this Order, (3) 25% of the total amount within onehundredeighty (180) days of the entry of this Order, and (4) 25% of the total amount within twohundredseventy (270) days of the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of disgorgement, prejudgment interest, and civil penalties, plus any additional interest accrued pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. § 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

(1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondents 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) Respondents 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 Mehron P. Azarmehr and Azarmehr Law Group as the Respondents 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 Stephen L. Cohen, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5553.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
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. 76570 / December 7, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16983**

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| **In the Matter of**<br><br>**ROGER A. BERNSTEIN**<br><br>**Respondent.** | **ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND 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 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Roger A. Bernstein ("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, and except as provided herein in Section V, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing 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**

1. Respondent violated Section 15(a)(1) of the Exchange Act by acting as an unregistered broker-dealer in connection with his representation of clients who were seeking U.S. residency through the Immigrant Investor Program. Respondent, an immigration attorney, recommended that his clients participate in the Immigration Investor Program by investing in securities offered through an EB-5 Regional Center and helped effect the purchases. In addition to receiving legal fees from his clients, Respondent received transaction-based compensation from the Regional Center for investments he facilitated.

**Respondent**

2. Roger A. Bernstein, age 48, is a resident of North Miami, Florida. He is a licensed attorney specializing in immigration. During the relevant time period, he was a partner of a law firm located in Miami, Florida.

**Background**

3. The United States Congress created the Immigrant Investor Program, also known as "EB-5," in 1990 to stimulate the U.S. economy through job creation and capital investment by foreign investors. The Program offers EB-5 visas to individuals who invest $1 million in a new commercial enterprise that creates or preserves at least 10 full-time jobs for qualifying U.S. workers (or $500,000 in an enterprise located in a rural area or an area of high unemployment). A certain number of EB-5 visas are set aside for investors in approved Regional Centers. A Regional Center is defined as "any economic unit, public or private, which is involved with the promotion of economic growth, including increased export sales, improved regional productivity, job creation, and increased domestic capital investment." 8 C.F.R. § 204.6(e) (2015).

4. Typical Regional Center investment vehicles are offered as limited partnership interests. The partnership interests are securities, usually offered pursuant to one or more exemptions from the registration requirements of the U.S. securities laws. The Regional Centers are often managed by a person or entity which acts as a general partner of the limited partnership. The Regional Centers, the investment vehicles, and the managers are collectively referred to herein as "EB-5 Investment Offerers."

5. Various EB-5 Investment Offerers paid commissions or other transaction-based compensation to anyone who successfully sold limited partnership interests to new investors.

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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.

**Respondent Received Transaction-Based Compensation for His Clients' EB-5 Investments**

6. From at least January 2010 through August 2012, Respondent received transaction-based compensation from one or more EB-5 Investment Offerers totaling $132,500.

7. Respondent performed activities necessary to effectuate the transactions in EB-5 securities, including recommending one or more EB-5 Investment Offerers to his clients; acting as a liaison between the EB-5 Investment Offerers and the investors; and facilitating the transfer and/or documentation of investment funds to the EB-5 Investment Offerers. Respondent received transaction-based compensation for his services from the EB-5 Investment Offerers. While some of Respondent's activities overlapped with legal services, for which he received fees, Respondent was paid transaction-based compensation for the activities which effectuated the investor's transactions in EB-5 securities.

8. As a result of the conduct described above, Respondent violated Section 15(a)(1) of the Exchange Act which makes it unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer to make use of the mails or any means or instrumentality of interstate commerce "to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act.

## IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Roger A. Bernstein's Offer.

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 15(a)(1) of the Exchange Act.

B. Respondent shall, within ten (10) days of the entry of this Order, pay disgorgement of $132,500 and prejudgment interest of $8,243 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). If timely payment of disgorgement and prejudgment interest is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 [17 C.F.R. § 201.600]. 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 Roger A. Bernstein 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 Stephen L. Cohen, Associate Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5553.

**V.**

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
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. 76571 / December 7, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16984**

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| **In the Matter of**<br><br>**ALLEN E. KAYE**<br><br>**Respondent.** | **ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, 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 cease-and-desist proceedings be, and hereby are, instituted pursuant to 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Allen E. Kaye ("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, and except as provided herein in Section V, Respondent consents to the entry of this Order Instituting Cease-and-Desist Proceedings, Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

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## III.

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

### Summary

1. Respondent violated Section 15(a)(1) of the Exchange Act by acting as an unregistered broker-dealer in connection with his representation of clients who were seeking U.S. residency through the Immigrant Investor Program. Respondent, an immigration attorney, advised his clients to buy securities through an EB-5 Regional Center and helped effect the purchases. In addition to receiving legal fees from his clients, Respondent received a commission from the Regional Center for each investment he facilitated.

### Respondent

2. Allen E. Kaye, age 76, is a resident of Hoboken, New Jersey. He is a licensed attorney specializing in immigration. During the relevant time period, he was a principal of a New York, New York law firm.

### Background

3. The United States Congress created the Immigrant Investor Program, also known as "EB-5," in 1990 to stimulate the U.S. economy through job creation and capital investment by foreign investors. The Program offers EB-5 visas to individuals who invest $1 million in a new commercial enterprise that creates or preserves at least 10 full-time jobs for qualifying U.S. workers (or $500,000 in an enterprise located in a rural area or an area of high unemployment). A certain number of EB-5 visas are set aside for investors in approved Regional Centers. A Regional Center is defined as "any economic unit, public or private, which is involved with the promotion of economic growth, including increased export sales, improved regional productivity, job creation, and increased domestic capital investment." 8 C.F.R. § 204.6(e) (2015).

4. Typical Regional Center investment vehicles are offered as limited partnership interests. The partnership interests are securities, usually offered pursuant to one or more exemptions from the registration requirements of the U.S. securities laws. The Regional Centers are often managed by a person or entity which acts as a general partner of the limited partnership. The Regional Centers, the investment vehicles, and the managers are collectively referred to herein as "EB-5 Investment Offerers."

5. Various EB-5 Investment Offerers paid commissions to anyone who successfully sold limited partnership interests to new investors.

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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.

**Respondent Received Commissions for His Clients' EB-5 Investments**

6. From at least January 2010 through January 2013, Respondent received commissions from one EB-5 Investment Offerer totaling $90,000.

7. Respondent performed activities necessary to effectuate the transactions in EB-5 securities, including recommending one or more EB-5 Investment Offerers to his clients; acting as a liaison between the EB-5 Investment Offerers and the investors; and facilitating the transfer and/or documentation of investment funds to the EB-5 Investment Offerers. Respondent received transaction-based commissions for his services from the EB-5 Investment Offerer. While some of Respondent's activities overlapped with legal services, for which he received fees, Respondent was paid transaction-based compensation for the activities which effectuated the investor's transactions in EB-5 securities.

8. As a result of the conduct described above, Respondent violated Section 15(a)(1) of the Exchange Act which makes it unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer to make use of the mails or any means or instrumentality of interstate commerce "to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security" unless such broker or dealer is registered in accordance with Section 15(b) of the Exchange Act.

**Disgorgement**

Respondent has submitted a sworn Statement of Financial Condition as of April 30, 2015 and other evidence and has asserted his inability to pay disgorgement plus prejudgment interest.

**IV.**

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent Allen E. Kaye's Offer.

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Section 15(a)(1) of the Exchange Act.

B. Respondent shall, within ten (10) days of the entry of this Order, pay disgorgement of $90,000 and prejudgment interest of $10,549, but that payment of such amount is waived based upon Respondent's sworn representations in his Statement of Financial Condition as of April 30, 2015 and other documents submitted to the Commission.

C. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondent provided accurate and complete financial information at the time such representations were made; and (2) seek an order directing payment of disgorgement and prejudgment interest. No other issue shall be considered in connection with this petition other than whether the financial information provided by Respondent was, in any material respect, fraudulent, misleading, inaccurate, or incomplete. Respondent may not, by way of defense to any such petition: (1) contest the findings in this Order; (2) assert that payment of disgorgement and interest should not be ordered; (3) contest the amount of disgorgement and interest to be ordered; or (4) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 4288 / December 8, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16988**

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| **In the Matter of**<br><br>**John Michael Babiarz,**<br><br>**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 John Michael Babiarz ("Respondent" or "Babiarz").

**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 admits the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Section III.2., below, and consents to the entry of this Order Instituting Administrative Proceedings Pursuant to Section 203(f) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

## III.

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

1. From at least September, 2011 through June, 2013, Babiarz—an individual who resided in Massachusetts—acted as an unregistered investment adviser. Prior to that, Babiarz had worked as a registered representative of several different broker-dealer firms from 2004 to September 1, 2011.

2. On August 21, 2014, before the United States District Court for the District of Massachusetts, in *United States of America v. John Michael Babiarz*, 13-cr-10334-FDS-1, Babiarz pled guilty to one count of wire fraud, in violation of 18 U.S.C. § 1343, and one count of aggravated identity theft, in violation of 18 U.S.C. § 1028A. On September 12, 2014, the U.S. District Court entered judgement, sentencing Babiarz to 48 months imprisonment and two years of supervised release and ordering Babiarz to pay restitution of $645,340.41 and a special assessment fee of $200.

3. In connection with his guilty plea, Babiarz admitted that, between September 2011 and June 2013, he obtained over $650,000 from various investors by holding himself out as an investment adviser and falsely representing that he would invest such monies on behalf of those investors. Following his termination in September 2011 from a retail brokerage firm headquartered in New York, Babiarz falsely told certain former clients that he had taken a job at a major Massachusetts-based asset management firm and told certain other former clients that he was working as an independent financial advisor. In fact, Babiarz did not work at the major Massachusetts-based asset management firm, and has never been employed by that firm. Babiarz told his clients that he could continue to manage their money if they opened brokerage accounts at a particular broker-dealer. Babiarz assisted the individuals in opening such accounts online, and in so doing, set up the user names and passwords for those accounts. Unbeknownst to his clients, Babiarz then caused their funds – or money he borrowed in their names on margin – to be diverted to accounts that he controlled at several banks and brokerage firms. Babiarz used the money to buy a new home and to pay other personal expenses.

## IV.

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

Accordingly, it is hereby ORDERED pursuant to Section 203(f) of the Advisers Act, that Respondent Babiarz 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;

[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.

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.

Brent J. Fields
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. 76582 / December 8, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16990**

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| **In the Matter of**<br><br>**Cadan Resources Corp.,**<br>**Consolidated Global Minerals Ltd.,**<br>**Doreal Energy Corp., and**<br>**GeoCan Energy Inc.**<br>**(a/k/a Arsenal Energy Inc.),**<br><br>**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 Cadan Resources Corp., Consolidated Global Minerals Ltd., Doreal Energy Corp., and GeoCan Energy Inc. (a/k/a Arsenal Energy Inc.).

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Cadan Resources Corp. (CIK No. 1217332) is a British Columbia corporation located in North Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Cadan Resources Corp. is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20FR-12G registration statement on February 28, 2003. As of December 1, 2015, the company's stock (symbol "CADAF") was traded on the over-the-counter markets.

2. Consolidated Global Minerals Ltd. (CIK No. 1172214) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Consolidated Global Minerals Ltd. is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20FR-12G registration statement on April 22, 2002.

3. Doreal Energy Corp. (CIK No. 1072147) is an Alberta corporation whose registration was struck by Alberta's corporate regulator for failure to file its annual return, and is located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Doreal Energy Corp. is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20FR-12G registration statement on October 4, 2000.

4. GeoCan Energy Inc. (a/k/a Arsenal Energy Inc.) ("GeoCan Energy") (CIK No. 1143883) is an Alberta corporation located in Calgary, Alberta, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). GeoCan Energy is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20FR-12G registration statement on June 28, 2001.

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.

Brent J. Fields
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. 76583 / December 8, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-16991

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| In the Matter of<br><br>Downer's Gap, Inc.<br>(a/k/a Downers Gap, Inc.),<br>DST Media, Inc., and<br>Lazare Kaplan International, Inc.,<br><br>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 Downer's Gap, Inc. (a/k/a Downers Gap, Inc.), DST Media, Inc., and Lazare Kaplan International, Inc.

II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENTS

1. Downer's Gap, Inc. (a/k/a Downers Gap, Inc.) ("Downer's Gap") (CIK No. 1416304) is a void Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Downer's Gap 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 August 31, 2008, which reported a net loss of $25,017 from the company's June 11, 2007 inception through August 31, 2008.

2. DST Media, Inc. (CIK No. 1158386) is a dissolved Delaware corporation located in Rochester, New York with a class of securities registered with the Commission

pursuant to Exchange Act Section 12(g). DST Media, Inc. is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended March 31, 2006, which reported a net loss of $3,028 from the company's August 13, 2001 inception through March 31, 2006.

3. Lazare Kaplan International, Inc. (CIK No. 202375) is a Delaware corporation located in New York, New York with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Lazare Kaplan International, Inc. is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended February 28, 2009, which reported a net loss of $6,421,000 for the prior nine months. As of December 1, 2015, the company's stock (symbol "LKII") was quoted on OTC Link (previously, "Pink Sheets") operated by OTC Markets Group, Inc. ("OTC Link") on any unsolicited basis only.

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/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.

Brent J. Fields
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. 76611 / December 10, 2015**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3725 / December 10, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16997**

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| **In the Matter of**<br><br>**JOSEPH E. MOHR, CPA**<br><br>**Respondent.** | **ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 4C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS** |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted against Joseph E. Mohr ("Respondent" or "Mohr") pursuant to Section 4C[1] of the Securities Exchange Act of 1934 ("Exchange Act") and Rules 102(e)(1)(ii) of the Commission's Rules of Practice.[2]

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1 Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

2 Rule 102(e)(1)(ii) provides, in pertinent part, that:

> The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct.

II.

In anticipation of the institution of these proceedings, 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, and except as provided herein in Section V, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 and 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[3] that:

## A. SUMMARY

From 2009 to 2012, Joseph Mohr performed engagement quality reviews in Florida for audits and interim reviews of public companies conducted by Messineo & Co., CPAs, LLC ("Messineo & Co."). At the time Mohr performed this work, he was not a licensed or registered Certified Public Accountant ("CPA") in Florida or in any state because he failed to renew his Illinois registration in 2009. Despite his lack of credentials, Mohr advertised himself as a "CPA" and used the abbreviation in his title and on his professional papers. Without a CPA license or registration, Mohr used the abbreviation "CPA" in violation of Florida law.

In 2012, Messineo & Co. issued audit reports and granted permission for its respective clients to use them without having received concurring approval from Mohr. To hide its transgressions of professional standards, Messineo & Co. asked Mohr to backdate the records of his reviews so that the records displayed dates prior to its issuance of the associated reports. Mohr agreed. For multiple issuers, Mohr backdated the records of his reviews.

By holding himself out as a Certified Public Accountant when he was not and by backdating documents to conceal violations of professional standards, Mohr engaged in improper professional conduct.

## B. RESPONDENT

**Joseph E. Mohr**, age 49, resides in Spring Hill, Florida and is currently a visiting assistant professor at a Florida university. In 1988, Mohr passed the Illinois CPA exam. He did not, however, pursue a CPA license. Later, in 2007, he became a "registered" CPA in Illinois. Mohr's registration expired on September 30, 2009. From 2009 to 2012, Mohr performed

[3] 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.

engagement quality reviews ("EQRs") for Messineo & Co. At the time, Mohr lived and worked in Florida, but was not licensed as a Certified Public Accountant ("CPA") in Florida or in any other state. In addition, Mohr has been a self-employed consultant specializing in the areas of business and finance and has served as Chief Financial Officer ("CFO") or acting or interim CFO for ten or more companies. Most recently in 2014, Mohr served as acting CFO for a Florida metal-working company and from 2010 to 2013 served as CFO for a Florida-headquartered oil and gas firm.

## C. OTHER RELEVANT PARTIES

**Messineo & Co., CPAs, LLC ("Messineo & Co.")** is registered with the Public Company Accounting Oversight Board ("PCAOB") as a public accounting firm based in Clearwater, Florida. The limited liability company operated as a sole proprietorship under the name Peter Messineo, CPA from 2009 until December 17, 2012, when it effectively merged with Drake & Klein, CPAs PA to form DKM Certified Public Accountants, Inc. ("DKM"). Peter Messineo separated from DKM in April 2013 and began operating Messineo & Co. again, but under its present name and form. During 2012, it performed audit services for over 70 clients, but only had one partner -- sole owner Peter Messineo -- authorized to sign or issue audit reports. From 2009 - 2012, Messineo & Co. paid Mohr to perform EQRs for its public company audit clients.

## D. MOHR FALSELY REPRESENTED HIMSELF AS A CERTIFIED PUBLIC ACCOUNTANT

1. In 1988, Mohr passed the Illinois CPA exam. Mohr, however, did not pursue a CPA license. Later, on April 5, 2007, he became a "registered" CPA under Illinois law. Mohr failed to renew his registration and it expired on September 30, 2009. Mohr never received his CPA license in Illinois, which would have permitted him to sign audits and reviews.

2. Mohr has never held a CPA license or registration from any other jurisdiction. Mohr has not taken any continuing education courses for accounting within the last 10 years.

3. After his CPA registration expired in 2009, Mohr continued to use the abbreviation "CPA" after his name and as part of his title in correspondence, invoices, and in connection with his work as an independent contractor. Mohr used the moniker "Joseph E. Mohr, CPA, MBA, Finance" to describe himself and his credentials.

4. When performing EQRs for Messineo & Co. from October 2009 through December 2012, Mohr continued to advertise himself as a CPA.

## E. BACKDATING DOCUMENTS

5. In 2012, Mohr performed EQRs for Messineo & Co. for its audits and interim reviews. To document Mohr's EQRs in compliance with auditing standards, Messineo & Co.

used a "Concurring Review Questionnaire," otherwise known as a "Form 4.2," in connection with each audit. See PCAOB Auditing Standard No. 7 ("AS 7").

6. After completing an EQR, Mohr was supposed to answer the questions on the Concurring Review Questionnaire and then sign and date the Questionnaire. The date on the form was to indicate when Mohr provided concurring approval of the issuance of the audit report. *See* AS 7.

7. Mohr then emailed the signed forms to Messineo & Co. where the executed Concurring Review Questionnaires were included within the firm's audit files. *See* PCAOB Auditing Standard No. 3 ("AS 3") & AS 7.

8. In August 2012, Messineo & Co. began to conduct a review of its audit files to identify any deficiencies and identified different engagements for which either:

   i. it was missing a Concurring Review Questionnaire signed by Mohr; or

   ii. the signed Concurring Review Questionnaire was dated after the audit report had been issued by Messineo & Co., indicating that Messineo & Co. had issued the audit report prior to Mohr's completion of his EQR.

9. As a result, Messineo & Co. personnel requested Mohr backdate his signature on Concurring Review Questionnaires for public company audit clients. Mohr complied. He knowingly misrepresented the dates that he completed the respective EQRs for at least three issuers.

10. Messineo & Co. personnel then inserted the backdated forms into its audit files, including into files which were putatively "locked-down" because the audit report had been issued more than 45 days previously. *See* PCAOB AS 3.

## F. MOHR'S USE OF THE ABBREVIATION "CPA" FROM OCTOBER 2009 THROUGH 2012 VIOLATED FLORIDA STATE LAW BECAUSE HE LACKED A LICENSE AS A CERTIFIED PUBLIC ACCOUNTANT.

11. Florida statute Section 473.322 *(Prohibitions; Penalties)* makes it a criminal violation for a person to knowingly assume or use:

> the titles or designations "certified public accountant" or "public accountant" or the abbreviation "C.P.A." or any other title, designation, words, letters, abbreviations, sign, card, or device tending to indicate that the person holds a license to practice public accounting under this chapter or the laws of any other state, territory, or foreign jurisdiction, unless the person holds an active license under this chapter or has the practice privileges pursuant to s. 473.3141;

12. As discussed above, Mohr fraudulently continued to use the abbreviation "CPA" in connection with his concurring reviews and his contracting work for several years after his registration from Illinois terminated on September 30, 2009.

13. Accordingly, Mohr engaged in improper professional conduct.

## G. MOHR'S BACKDATING OF DOCUMENTS VIOLATES PCAOB STANDARDS.

14. PCAOB Auditing Standard No. 7 (Engagement Quality Review) enumerates the standards for an EQR or concurring review. AS 7 requires an EQR to be performed for every audit and interim review. See PCAOB AS 7.1.

15. For both audits and interim reviews, AS 7 prohibits the firm from granting permission to the client to use the engagement report until the engagement quality reviewer provides concurring approval of issuance. See PCAOB AS 7.13 & AS 7.18.

16. AS 7 requires that "an engagement quality reviewer must have competence, independence, integrity, and objectivity." *See* PCAOB AS 7.14.

17. AS 7 requires that documentation of an EQR should "contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer…to comply with the provisions of this standard, including information that identifies:

* * *

> c. The date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval."

*See* PCAOB AS 7.19.

18. AS 7 also states that "[d]ocumentation of an engagement quality review should be included in the engagement documentation" and that "[t]he requirements related to retention of and subsequent changes to audit documentation in PCAOB Auditing Standard No. 3, Audit Documentation, apply with respect to the documentation of the engagement quality review." *See* PCAOB AS 7.20 & AS 7.21.

19. PCAOB AU 230 (*Due Professional Care in the Performance of Work*) "requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting." *See* PCAOB AU 230.02.

20. Mohr violated AS 7 and AU 230 when he performed EQRs after the respective audit report was issued and backdated his signature on the Concurring Review

Questionnaires (Form 4.2s) -- at Messineo & Co.'s request -- to a date before the issuance of the audit report.

## H. VIOLATIONS

21. As a result of the conduct described above, Mohr engaged in improper professional conduct as defined in Rule 102(e)(1)(iv) of the Commission's Rules of Practice, in that Mohr violated applicable professional standards or committed repeated instances of unreasonable negligent conduct each resulting in a violation of applicable professional standards that indicate a lack of competence to practice before the Commission.

## I. FINDINGS

22. Based on the foregoing, the Commission finds that Mohr engaged in improper professional conduct pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

## IV.

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

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

A. Mohr is denied the privilege of appearing or practicing before the Commission as an accountant. After 4 years from the date of this order, Mohr 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 an accountant.

By the Commission.

Brent J. Fields
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. 76610 / December 10, 2015**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3724 / December 10, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16996**

| In the Matter of | ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 4C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS |
|---|---|
| ROBIN L. BIGALKE, CPA | |
| Respondent. | |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted against Robin L. Bigalke ("Respondent" or "Bigalke") pursuant to Section 4C[1] of the Securities Exchange Act of 1934 ("Exchange Act") and Rules 102(e)(1)(ii) of the Commission's Rules of Practice.[2]

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1 Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

2 Rule 102(e)(1)(ii) provides, in pertinent part, that:

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## II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over him and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondent consents to the entry of this Order Instituting Public Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 and 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[3] that:

### A. SUMMARY

During 2012, Bigalke falsified and backdated audit documents in an attempt to hide improprieties and documentation deficiencies at the audit firm Peter Messineo, CPA, which is now known as Messineo & Co., CPAs, LLC ("Messineo & Co."). At the time, Messineo & Co. was subject to a follow-up inspection by the Public Company Accounting Oversight Board ("PCAOB") and an investigation subpoena from the Commission.

### B. RESPONDENT

**Robin L. Bigalke**, age 50, resides in Gulfport, Florida and currently owns RLB Certified Public Accountant, a PCAOB-registered public accounting firm based in Gulfport, Florida. During 2012, Bigalke was a senior accountant at Messineo & Co., then known as Peter Messineo, CPA. Bigalke has been licensed as a Certified Public Accountant ("CPA") in Rhode Island since 2001 and in Florida since 2014.

### C. OTHER RELEVANT PARTIES

**Messineo & Co., CPAs, LLC ("Messineo & Co.")** is registered with the Public Company Accounting Oversight Board ("PCAOB") as a public accounting firm based in Clearwater, Florida. The limited liability company operated as a sole proprietorship under the

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> The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct.

3 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.

name Peter Messineo, CPA from 2009 until December 17, 2012, when it effectively merged with Drake & Klein, CPAs PA to form DKM Certified Public Accountants, Inc. ("DKM"). Peter Messineo separated from DKM in April 2013 and resumed operating Messineo & Co., but under its present name and form. During 2012, it performed audit services for over 70 clients, but only had one partner -- sole owner Peter Messineo -- authorized to sign or issue audit reports. In 2012, Messineo & Co. employed Bigalke and paid Joseph E. Mohr to perform engagement quality reviews ("EQRs").

**Joseph E. Mohr**, age 49, resides in Spring Hill, Florida and is currently a visiting assistant professor at a Florida university. From 2009 through 2012, Mohr performed engagement quality reviews ("EQRs") for Messineo & Co. At the time, Mohr lived and worked in Florida, but was not licensed as a CPA in Florida or in any other state.

## D. BACKDATING ENGAGEMENT QUALITY REVIEW DOCUMENTS

1. In 2012, Mohr performed EQRs for Messineo & Co. for its audits and interim reviews. To document Mohr's EQRs in compliance with auditing standards, Messineo & Co. used a "Concurring Review Questionnaire," otherwise known as a "Form 4.2," in connection with each audit. *See* PCAOB Auditing Standard No. 7 ("AS 7").

2. After completing an EQR, Mohr was supposed to answer the questions on the Concurring Review Questionnaire and then sign and date the Questionnaire. The date on the form was to indicate when Mohr provided concurring approval of the issuance of the audit report. *See* AS 7.

3. Mohr then emailed the signed forms to Messineo & Co. where the executed Concurring Review Questionnaires were included in the firm's audit files. *See* PCAOB Auditing Standard No. 3 ("AS 3") & AS 7.

4. In April 2012, the PCAOB issued a report following its inspection of Messineo & Co.'s audit files. The PCAOB's inspection addressed Messineo & Co.'s practices, policies and procedures related to audit quality. The report stated that Messineo & Co. needed to address any defects in its quality control system within 12 months or the nonpublic portion of the PCAOB's report would be made public.

5. Following the PCAOB's inspection report, in August 2012, Messineo & Co. began to conduct a review of its audit files to identify any deficiencies and identified different engagements for which either:

    i. it was missing a Concurring Review Questionnaire signed by Mohr; or

    ii. the signed Concurring Review Questionnaire was dated after the audit report had been issued by Messineo & Co., indicating that Messineo & Co. had issued the audit report prior to Mohr's completion of his EQR.

6. As a result, Bigalke requested Mohr backdate his signature on Concurring Review Questionnaires for multiple public company audit clients. Bigalke even requested Mohr backdate documents responsive to an investigation subpoena served by the Commission on Messineo & Co.

7. Mohr complied with many -- if not all -- of Bigalke's requests. He knowingly misrepresented the dates that he completed his EQRs.

8. Bigalke then inserted the backdated Questionnaires into Messineo & Co.'s audit files, including into files which were -- pursuant to auditing standards – putatively "locked-down" because the audit report had been issued more than 45 days previously. *See* PCAOB AS 3.

**E. FALSIFICATION OF AUDIT DOCUMENTS**

9. In 2012, Bigalke completed various audit checklists and forms, including "Audit Documentation Checklists" and "Supervision, Review, and Approval Forms," on behalf of Messineo & Co. in connection with various engagements, including two specific issuers.

10. On the audit forms for those two issuers, Bigalke signed Peter Messineo's name and initials on his behalf. By signing Messineo's name, she represented that the EQR was adequately performed, timely, and that the audit files contained documentation of the EQRs.

11. The representations on the forms were false. As of the date indicated on the respective forms, neither Mohr -- nor anyone else -- had performed the EQRs for those issuers and no corresponding documentation existed in Messineo & Co.'s audit files. These false documents were then inserted into Messineo & Co.'s audit files.

**F. BIGALKE'S FAILED TO EXERCISE PROFESSIONAL DUE CARE WHEN SHE PARTICIPATED IN A SCHEME TO BACKDATE DOCUMENTS IN VIOLATION OF PCAOB STANDARDS.**

15. PCAOB Interim Auditing Standard AU 230 (*Due Professional Care in the Performance of Work*) "requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting." *See* PCAOB AU 230.02.

16. Bigalke violated AU 230 when she requested Mohr backdate his signature on the Concurring Review Questionnaires (Form 4.2s) to a date before the issuance of the audit report when he had not, in fact, concluded his review and provided concurring approval of issuance by that date.

17. PCAOB Auditing Standard No. 7 (*Engagement Quality Review*) enumerates the standards for an EQR or concurring review. AS 7 requires an EQR to be performed for every audit and interim review. *See* PCAOB AS 7.1.

18. For both audits and interim reviews, AS 7 prohibits a firm from granting permission to its client to use the engagement report until the engagement quality reviewer provides concurring approval of issuance. *See* PCAOB AS 7.13 & AS 7.18.

19. AS 7 requires that "an engagement quality reviewer must have competence, independence, integrity, and objectivity." *See* PCAOB AS 7.4.

20. AS 7 requires that documentation of an EQR should "contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer...to comply with the provisions of this standard, including information that identifies:

* * *

c. The date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval."

*See* PCAOB AS 7.19.

21. Bigalke further violated AU 230 and AS 3 when she inserted the backdated and falsified Concurring Review Questionnaires into Messineo & Co.'s audit files. This violation was compounded by the fact that the addition occurred more than 45 days after the report release date without indication of the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it. *See* PCAOB AS 3.15.

22. AS 7 states that "[d]ocumentation of an engagement quality review should be included in the engagement documentation" and that "[t]he requirements related to retention of and subsequent changes to audit documentation in PCAOB Auditing Standard No. 3, Audit Documentation, apply with respect to the documentation of the engagement quality review." *See* PCAOB AS 7.20 and 7.21.

23. PCAOB Auditing Standard No. 3 (*Audit Documentation*) provides the requirements for documentation an auditor should prepare and retain for engagements. Per AS 3, audit documentation must document the nature, *timing*, and results of the procedures performed. *See* PCAOB AS 3.6

24. AS 3 requires an auditor to assemble a complete and final set of audit documentation no more than 45 days of the report release date ("documentation completion date"). Audit documentation may not be deleted or discarded following the documentation completion

date. AS 3 mandates that any documentation added after the document completion date "must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it." *See* PCAOB AS 3.15 and 3.16.

25. Therefore, Bigalke violated AU 230 and AS 3 when she falsified audit documentation and included it within the audit files.

**G. Violations**

27. As a result of the conduct described above, Bigalke engaged in improper professional conduct as defined in Rule 102(e)(1)(iv) in that she violated applicable professional standards or committed repeated instances of unreasonable negligent conduct each resulting in a violation of applicable professional standards that indicate a lack of competence to practice before the Commission.

**H. Findings**

28. Based on the foregoing, the Commission finds that Bigalke engaged in improper professional conduct pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

**IV.**

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

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

A. Bigalke is denied the privilege of appearing or practicing before the Commission as an accountant.

B. After 3 years from the date of this order, Bigalke 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 Bigalke'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) Bigalke, 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) Bigalke, 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 Bigalke's or the firm's quality control system that would indicate that Bigalke will not receive appropriate supervision;

(c) Bigalke 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) Bigalke acknowledges her responsibility, as long as she 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.

3. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that her CPA license is current and she has resolved all other disciplinary issues with the applicable boards of accountancy. However, if CPA licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its own 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.

Brent J. Fields
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. 76608 / December 10, 2015**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3722 / December 10, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16994**

| | |
|---|---|
| **In the Matter of**<br><br>**DKM CERTIFIED PUBLIC ACCOUNTANTS, INC., CHARLES U. KLEIN, CPA**<br><br>**Respondents.** | **ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER** |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted against DKM Certified Public Accountants, Inc. ("DKM") and Charles U. Klein ("Klein") (together "Respondents") pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.[2]

1 Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

2 Rule 102(e)(1)(ii) provides, in pertinent part, that:

## II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or 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, and except as provided herein in Section V, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

## III.

On the basis of this Order and Respondents' Offer, the Commission finds[3] that:

### A. SUMMARY

DKM is a small, Florida-based accounting firm. Among other things, it has performed audits of public companies whose stock is registered with the Commission and who file audited financial statements with the Commission. Klein is a partner at and part owner of DKM. DKM was not independent of three public company audit clients that they audited in 2012 and 2013.

In 2012 – 2013, Respondents audited and reviewed the annual and quarterly financial statements of Issuer A and Issuer B (described below). Klein was the lead engagement partner, and Richard Confessore was the engagement quality reviewer. During these engagements, Klein caused DKM to not be independent of Issuer A or Issuer B because of business, employment, and financial relationships involving Respondents and its clients.

First, at the same time Confessore performed engagement quality reviews for DKM on the 2012 Issuer A and Issuer B audit and interim reviews, he had a business relationship with Issuer A's

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> The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct.

Rule 102(e)(1)(iii) provides, in pertinent part, that:

> The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found...to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

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

and Issuer B's Chief Financial Officer ("CFO"), Peter Messineo, who employed Confessore at Messineo's own audit firm, Messineo & Co., CPAs, LLC ("Messineo & Co.").

Second, in late 2012, Messineo resigned as CFO of Issuer A and Issuer B and became a shareholder and partner at DKM. DKM continued to provide audit services to both Issuer A and Issuer B even though: (1) the companies' former CFO was now a shareholder and partner at DKM and in a position to influence the audits and reviews, and (2) Messineo had been the CFO during the audit periods.

Third, at the time DKM performed the audit and interim review of Issuer A and Issuer B in early 2013, Messineo owned stock in both Issuer A and Issuer B. Klein knew that Messineo owned this stock -- more than 5% of Issuer A's outstanding shares -- when DKM conducted the audit and review.

In addition, in 2013, DKM audited Issuer C's annual financial statement covering the period from April 1, 2011 – March 31, 2012. Confessore participated in the audit despite having served as Issuer C's CFO during the audit period.

Performing these audits and reviews for Issuer A, Issuer B, and Issuer C violated the independence rules of the Federal securities laws and the rules and regulations thereunder. DKM's and Klein's conduct was willful and constitutes improper professional conduct.

## B. RESPONDENTS

**DKM Certified Public Accountants, Inc. ("DKM")** is registered with the Public Company Accounting Oversight Board ("PCAOB") as a public accounting firm based in Clearwater, Florida. DKM is a Florida corporation and successor to audit firms: (i) Drake Klein & Messineo CPAs PA; and (ii) Drake & Klein, CPAs PA ("Drake & Klein"). In December 2012, when Peter Messineo joined DKM, the firm changed its operational name from Drake & Klein to DKM. As of December 2012, DKM had four partners authorized to issue audit reports on behalf of the firm, including Messineo, Confessore, and Charles Klein.

**Charles U. Klein**, age 60, resides in Dunedin, Florida and is currently President of DKM. From approximately February 2012 through June 2013, Klein was the lead engagement partner for the services DKM performed for Issuer A, Issuer B, and Issuer C. These services included annual audits and interim reviews of the financial statements of Issuer A, Issuer B, and Issuer C. Klein has been a licensed Certified Public Accountant ("CPA") in Florida since 1985, excluding 1995 to 1998 when his license was inactive.

## C. OTHER RELEVANT PARTIES

**Issuer A** was incorporated in Delaware in 2005 and is currently headquartered in California. During 2012 and 2013, Issuer A's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. In its most recent Form 10-K filed with the Commission, Issuer A states that its business "offers marketing tools and expertise to advertisers that combine the quality and power of Flash video, interactive features, the ability to update their information and add special events immediately and as frequently as desired." From February 2010 to November 2012, Messineo served as CFO of Issuer A. In 2012 and 2013, Issuer A engaged DKM to perform audit services.

**Issuer B** was incorporated in Nevada in 2004 and is currently headquartered in St. Petersburg, FL. During 2012 and 2013, Issuer B's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. In its most recent Form 10-K filed with the Commission, Issuer B states that its business "creates a unified solution path to securely manage Advanced Metering Infrastructure and other Smart Grid optimization applications such as substation and distribution automation." From September 2010 to October 2012, Messineo served as CFO of Issuer B. In 2012 and 2013, Issuer B engaged DKM to perform audit services.

**Issuer C** was incorporated in Colorado in 1981. Currently, it is a Florida corporation headquartered in Southbury, CT. During 2012 and 2013, Issuer C's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. In its most recent Form 10-K filed with the Commission, Issuer C states that its business consists of "operating motor freight carriers, providing truck load service throughout the forty-eight contiguous United States." Confessore resigned as CFO of Issuer C on April 12, 2011. In 2012, Issuer C engaged Messineo & Co. to provide audit services. Messineo & Co. did not issue an audit report before DKM was formed. In 2013, Issuer C then engaged DKM to provide audit services for the same period for which Messineo & Co. had been retained.

**Richard Confessore**, age 73, resides in Sarasota, Florida and has been a licensed CPA in Florida since 1970. Confessore is currently a Director and "Quality Review Partner" at DKM. During 2011, Confessore was the CFO and worked at Issuer C. During 2012-2013, Confessore performed engagement quality reviews for the annual audits and interim reviews DKM performed for Issuers A and B. In addition, from June 2012 to December 2012, Confessore was an employee for Messineo & Co, then a sole proprietorship owned by Peter Messineo, the CFO for both Issuer A and Issuer B.

**Peter Messineo**, age 54, resides in Palm Harbor, Florida and is currently a partner at and 95% owner of Messineo & Co., which is a PCAOB-registered public accounting firm based in Clearwater, Florida. In 2012, he was the sole owner of Messineo & Co. (then named "Peter Messineo, CPA") and CFO of Issuer A and Issuer B. From December 17, 2012 to April 16, 2013, Messineo was a partner and one third owner of DKM and a shareholder of Issuer A and Issuer B stock. Messineo has been licensed as a CPA in New York since 1989 and in Florida since 2007.

## D. IN 2012, AS LEAD ENGAGEMENT PARTNER KLEIN CAUSED DKM (THEN KNOWN AS DRAKE & KLEIN) NOT TO BE INDEPENDENT WHEN DKM CONDUCTED AUDITS AND REVIEWS OF ISSUER A AND ISSUER B.

1. Issuer A engaged DKM to perform reviews for the quarters ending June 30, 2012 (Form 10-Q filed August 14, 2012) and September 30, 2012 (Form 10-Q filed November 14, 2012). Klein was DKM's lead engagement partner and Confessore was DKM's engagement quality review ("EQR") partner on these engagements.

2. During the audit and professional engagement periods for these Issuer A engagements, Messineo was Issuer A's CFO.

3. Issuer B engaged DKM to perform audit services for the annual period ending June 30, 2012 (Form 10-K filed October 15, 2012) and the quarter ending September 30, 2012 (Form 10-Q filed November 14, 2012). Klein was DKM's lead engagement partner and Confessore was DKM's EQR partner on these engagements.

4. During the audit and professional engagement periods for these Issuer B engagements, Messineo was Issuer B's CFO.

5. In June 2012, Messineo hired Confessore to work for him at Messineo & Co. Confessore worked at Messineo & Co. until mid-December 2012. Thus, Confessore worked under Messineo -- the CFO of both Issuer A and Issuer B -- at the same time Confessore conducted quality reviews for DKM of: (i) Issuer A's interim financial statements filed August 14, 2012 and November 14, 2012; and (ii) Issuer B's annual financial statement filed October 15, 2012 (amended October 22, 2012). Confessore also worked for Messineo during the entire audit period of Issuer B's interim financial statements, filed November 14, 2012, which DKM and Confessore reviewed.

6. Confessore's employment with Messineo constituted an improper business relationship and conflict of interest.

7. Rule 2-01(b) of Regulation S-X (*Qualifications of Accountants*) states that the "Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not...capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement." 17 CFR §210.2-01.

8. Rule 2-01(c)(3) states certain "business relationships" are inconsistent with independence:

> *Business Relationships.* An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders.

17 CFR §210.2-01(c)(3)

9. Rule 2-01(f)(11) defines "covered person" to include partners, principals, shareholders, and employees of an accounting firm on the "audit engagement team." 17 CFR §210.2-01(f)(11). The "audit engagement team" includes the "concurring or reviewing partner." 17 CFR §210.2-01(f)(7)(ii)(B).

10. PCAOB standards also require auditor independence. PCAOB Rule 3520 (*Auditor Independence*) requires that, "[a] registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period."

11. PCAOB Auditing Standard No. 7 (*Engagement Quality Review*) requires that "an engagement quality reviewer must have competence, independence, integrity, and objectivity." *See* PCAOB AS 7.4.

12. PCAOB Interim Auditing Standard AU 230 (*Due Professional Care in the Performance of Work*) "requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting." *See* PCAOB AU 230.02.

13. DKM was not independent of Issuer A and Issuer B with respect to DKM's audit and interim reviews of financial statements filed from August 2012 through November 2012 because Confessore -- the engagement quality reviewer -- had a direct business relationship with Messineo -- the CFO of clients Issuer A and Issuer B -- during DKM's audit and professional engagement periods. *See* Rule 2-01(c)(3) of Regulation S-X.

14. As lead engagement partner, Klein was responsible for ensuring DKM was independent of Issuer A and Issuer B.

## E. IN 2013, AS LEAD ENGAGEMENT PARTNER KLEIN CAUSED DKM NOT TO BE INDEPENDENT OF ISSUER A AND ISSUER B.

15. Messineo resigned as CFO of Issuer A effective November 15, 2012 and as CFO of Issuer B effective October 30, 2012.

16. In mid-December 2012, Messineo joined DKM. Messineo was a one-third owner of DKM. While not a shareholder, Confessore was also a partner authorized to issue audit reports on behalf of DKM.

17. Issuer A engaged DKM to perform audit services for the annual period ending December 31, 2012 (Form 10-K filed April 15, 2013). Klein was DKM's lead engagement partner and Confessore was DKM's EQR partner on this engagement.

18. Issuer B engaged DKM to perform interim review services for the quarter ending December 31, 2012 (Form 10-Q filed February 19, 2013). Klein was DKM's lead engagement partner and Confessore was DKM's EQR partner on this engagement. DKM lacked independence because Messineo, Klein's partner at DKM, had financial and employment relationships with Issuer A and Issuer B.

19. Rule 2-01(c)(1) (*Financial Relationships*) states that an accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a "direct financial interest" in the accountant's audit client, including when:

> A. The accounting firm [or] any covered person in the firm...has any direct investment in an audit client, such as stocks, bonds, notes, options, or other securities.
>
> * * *
>
> B. Any partner, principal, shareholder, or professional employee of the accounting firm...has filed a Schedule 13D...with the Commission indicating beneficial ownership of more than five percent of an audit client's securities.

17 CFR §210.2-01(c)(1)(i)(A)-(B)

20. Rule 2-01(f)(11) defines "covered person" to include any "other partner, principal, or shareholder from an 'office' of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit." 17 CFR §210.2-01(f)(11). "Office" means "a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines." 17 CFR §210.2-01(f)(15).

21. Rule 2-01(c) (2) (*Employment Relationships*) states that an accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an "employment relationship" with an audit client, including when:

> A former officer, director, or employee of an audit client becomes a partner, principal, shareholder, or professional employee of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit covering any period during which he or she was employed by or associated with that audit client.

17 CFR §210.2-01(2)(iv) (*Employment at Accounting Firm of Former Employee of Audit Client*).

22. From December 2012 to April 2013, Messineo worked at DKM's small office in Clearwater, Florida along with Klein and approximately 6-8 staff personnel. Messineo's office was less than 10 feet away from the offices of those providing audit services to Issuer A and Issuer B.

23. From December 2012 to April 2013, Messineo had access to all of DKM's audit files, including those for the audit of Issuer A and the interim review of Issuer B. Messineo supervised the audit staff at DKM, including the audit manager who worked on the Issuer A audit, in some of DKM's other engagements.

24. During a significant portion of the professional engagement period for DKM's audit of Issuer A, Messineo possessed Issuer A's books and records.

25. During Messineo's tenure as a shareholder and partner at DKM, he owned stock in DKM's clients Issuer A and Issuer B. As of April 15, 2013, when Issuer A's Form 10-K was filed, Messineo owned approximately 6% of the outstanding shares of Issuer A stock.

26. Klein knew Messineo owned stock in Issuer A and Issuer B during the audit and professional engagement periods for those clients. Despite this knowledge, Klein performed audit services for Issuer A and Issuer B.

27. DKM was not independent of Issuer A and Issuer B with respect to their public filings made in February 2013 and April 2013 because Messineo -- a partner and shareholder of DKM -- possessed a direct financial interest (stock ownership) in clients Issuer A and Issuer B during DKM's audit and professional engagement periods. *See* Rule 2-01(c)(1) of Regulation S-X.

28. DKM was not independent of Issuer A and Issuer B with respect to their public filings made in February 2013 and April 2013 because Messineo -- a partner and shareholder of DKM -- was the CFO of Issuer A and Issuer B during the audit period and in a position to influence DKM's audit and interim reviews. *See* Rule 2-01(c)(2) of Regulation S-X.

## F. IN 2013, AS LEAD ENGAGEMENT PARTNER KLEIN CAUSED DKM NOT TO BE INDEPENDENT BY EMPLOYING ISSUER C'S FORMER CFO TO AUDIT ISSUER C FOR THE PERIOD HE WAS CFO.

29. Confessore was the CFO of Issuer C until April 12, 2011. Following his resignation, Confessore made himself available to Issuer C on a part-time basis to assist with accounting matters. On June 29, 2011, Issuer C filed a "Notification of Late Filing" for its Form 10-K. The notification explained that Issuer C was unable to complete its accounting at the subsidiary level. Issuer C's notification identified Confessore as the person to contact in regard to the notification.

30. In 2012, Issuer C engaged Messineo & Co. to perform audit services. Confessore performed work for Messineo & Co. concerning Issuer C, including the period for which he had been CFO and worked for Issuer C.

31. In 2013, DKM agreed to audit Issuer C's financial statements for the period from April 1, 2011 through March 31, 2012 despite Confessore's prior position as CFO of Issuer C during that time period. Klein knew that Confessore had been the CFO of Issuer C. DKM incorporated Messineo & Co.'s work into its audit of Issuer C, including Confessore's work. On behalf of DKM, Klein signed the engagement report issued to Issuer C in June 2013.

32. DKM was not independent of client Issuer C with respect to its public filings made in June 2013 because Confessore – a partner of DKM – participated in the audit of Issuer C, which covered the period Confessore had been the CFO and/or worked for Issuer C. *See* Rule 2-01(c)(2) of Regulation S-X.

## G. KLEIN AIDED AND ABETTED AND CAUSED DKM'S VIOLATION OF RULE 2-02 OF REGULATION S-X BECAUSE DKM'S AUDIT REPORTS DID NOT COMPLY WITH PCAOB STANDARDS.

33. Rule 2-02(b)(1) of Regulation S-X (*Representations as to the Audit included in Accountants' Reports*) requires an accountant's report to state "whether the audit was made in accordance with generally accepted auditing standards." 17 CFR §210.2-02(b). These standards include the standards of the PCAOB. "[R]eferences in Commission rules and staff guidance and in the federal securities laws to [generally accepted auditing standards "GAAS"] or to specific standards under GAAS, as they related to issuers, should be understood to mean the standards of the PCAOB plus any applicable rules of the Commission." *See* SEC Release No. 34-49708.

34. DKM issued audit reports for its audits of Issuer C, Issuer A, and Issuer B for fiscal years ending March 31, 2012, December 31, 2012 and June 30, 2012, respectively. As lead engagement partner, Klein signed the audit reports on behalf of DKM. The audit reports incorrectly state that DKM "conducted [its] audit in accordance with the standards of the Public Company Accounting Oversight Board (United States)."

35. DKM's audits were not conducted in accordance with PCAOB auditing standards because they lacked independence as described above. *See* PCAOB Rule 3520 (requiring independence); AS 7 (same).

36. Accordingly, DKM violated and Klein aided and abetted and caused violations of Rule 2-02 of Regulation S-X.

## H. RESPONDENTS CONDUCT CAUSED ISSUER A, ISSUER B, AND ISSUER C TO FILE FALSE OR MISLEADING REPORTS WITH THE COMMISSION IN VIOLATION OF SECTION 13(a) OF THE EXCHANGE ACT AND RULES 13a-1 AND 13a-13 PROMULGATED THEREUNDER.

37. Exchange Act Section 13(a) and Rules 13a-1 and 13a-13 require an issuer to file accurate annual and quarterly reports on Form 10-K and Form 10-Q, respectively.

38. Section 13(a) of the Exchange Act requires issuers to file annual reports certified by "independent public accountants." Rule 10-01(d) of Regulation S-X requires that prior to filing, interim financial statements included in quarterly reports on Form 10-Q "must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews…." 17 CFR §210.10-01(d).

39. Respondents caused Issuer A, Issuer B, and Issuer C to violate Section 13(a) and Rule13a-1 thereunder by causing them to file annual reports for the years ended March 31, 2012, December 31, 2012 and June 30, 2012, respectively not certified by independent public accountants, and by causing them to file annual reports that included an audit report that incorrectly stated it had been conducted by an independent public accounting firm in accordance with the standards of the PCAOB.

40. Respondents caused Issuer A and Issuer B to violate Section 13(a) and Rule 13a-13 thereunder by causing them to file quarterly reports which had not previously been reviewed by independent public accountants.

## I. VIOLATIONS

41. As a result of the conduct described above, DKM willfully[4] violated and Klein willfully aided and abetted and caused a violation of Rule 2-02 of Regulation S-X.

42. As a result of the conduct described above, DKM and Klein caused Issuer A, Issuer B, and Issuer C to violate Section 13(a) of the Exchange Act and Rules 13a-1 thereunder.

43. As a result of the conduct described above, DKM and Klein caused Issuer A and Issuer B to violate Section 13(a) of the Exchange Act and Rules 13a-13 thereunder.

44. As a result of the conduct described above, DKM and Klein engaged in improper professional conduct as defined in Rule 102(e)(1)(iv) in that DKM and Klein committed intentional and knowing conduct that resulted in a violation of applicable professional standards or committed repeated instances of unreasonable negligent conduct each resulting in a violation of applicable professional standards that indicate a lack of competence to practice before the Commission.

## J. FINDINGS

45. Based on the foregoing, the Commission finds that Klein and DKM engaged in improper professional conduct pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

46. Based on the foregoing, the Commission finds that Klein and DKM willfully violated, or willfully aided and abetted the violation of, provisions of the Federal securities laws

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[4] A finding of willfulness does not require intent to violate, but merely intent to do the act which constitutes a violation. *SEC v. K.W. Brown & Co.*, 555 F. Supp. 2d 1275, 1309 (S.D. Fla.2007), citing *Wonsover v. SEC*, 205 F.3d 408, 413-15 (D.C. Cir. 2000); *SEC v. Steadman*, 603 F.2d 1126, 1135 (5th Cir. 1979); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 (2d Cir. 1976).

and the rules and regulations thereunder pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

47. Based on the foregoing, the Commission finds that Klein: (a) willfully aided and abetted and caused a violation of Rule 2-02 of Regulation S-X; and (b) willfully caused Issuer A's, Issuer B's, and Issuer C's violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

48. Based on the foregoing, the Commission finds that DKM: (a) willfully violated Rule 2-02 of Regulation S-X; and (b) willfully caused Issuer A's, Issuer B's, and Issuer C's violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

## K. RESPONDENTS' REMEDIAL EFFORTS

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

## IV.

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

Accordingly, pursuant to Sections 4C and 21C of the Exchange Act, it is hereby ORDERED, effective immediately, that:

A. Respondents shall cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act, Rules 13a-1 and 13a-13 promulgated thereunder, and Rule 2-02 of Regulation S-X.

B. Respondents are denied the privilege of appearing or practicing before the Commission as an accountant.

C. After 2 years from the date of this order, Klein 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 Klein'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) Klein, 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) Klein, 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 Klein's or the firm's quality control system that would indicate that the Klein will not receive appropriate supervision;

(c) Klein 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) Klein acknowledges his responsibility, as long as Klein 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.

3. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his CPA license is current and he has resolved all other disciplinary issues with the applicable boards of accountancy. However, if CPA licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its own 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.

D. After 2 years from the date of this order, DKM may request that the Commission consider its 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 DKM's work in its practice before the Commission will be reviewed either by the independent audit committee of the public company for which it works or in some other acceptable manner, as long as it practices before the Commission in this capacity; and/or

2. an independent accountant.

Such an application must satisfy the Commission that:

(a) Respondent DKM 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. However, if registration with the Board is dependent upon reinstatement by the Commission, the Commission will consider an application on its other merits;

(b) DKM hired an independent CPA consultant ("consultant"), who is not unacceptable to the staff of the Commission and is affiliated with a public accounting firm registered with the Board, that has conducted a review of DKM's quality control system and submitted to the staff of the Commission a report that describes the review conducted and procedures performed, and represents that the review did not identify any criticisms of or potential defects in the firm's quality control system that would indicate that any of DKM's employees will not receive appropriate supervision. DKM agrees to require the consultant, if and when retained, to enter into an agreement that provides that for the period of review and for a period of two years from completion of the review, the consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with DKM, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity. The agreement will also provide that the consultant will require that any firm with which he/she is affiliated or of which he/she is a member, and any person engaged to assist the consultant in performance of his/her duties under this Order shall not, without prior written consent of the staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with DKM, or any of its present or former affiliates, directors, officers, employees, or agents acting in their capacity as such for the period of the review and for a period of two years after the review.

(c) DKM 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) DKM acknowledges its responsibility, as long as DKM 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.

3. The Commission will consider an application by DKM to resume appearing or practicing before the Commission provided that its CPA license is current and it has resolved all other disciplinary issues with the applicable boards of accountancy.

However, if CPA licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its own 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.

E. DKM and Klein shall jointly and severally pay disgorgement, which represents profits gained as a result of the conduct described herein of $33,000, prejudgment interest of $2,043.87, and a civil money penalty in the amount of $25,000 to the Securities and Exchange Commission. Payment shall be made in the following four installments:

Within 14 days of the issuance of this Order $15,010.97

Within 90 days of the issuance of this Order $15,010.97

Within 180 days of the issuance of this Order $15,010.97

Within 270 days of the issuance of this Order $15,010.96

If any payment is not made by the date the payment is required by this Order, the entire outstanding balance, plus any additional interest accrued pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. §3717, shall be due and payable immediately without further application.

F. 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 DKM and Klein as Respondents 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 John T. Dugan, Associate Regional Director, Boston regional Office, Securities and Exchange Commission, 33 Arch Street, Boston, MA 02110.

By the Commission.

Brent J. Fields
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. 76607 / December 10, 2015**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3721 / December 10, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16993**

| | |
|---|---|
| **In the Matter of**<br><br>**PETER MESSINEO, CPA and MESSINEO & CO., CPAS, LLC,**<br><br>**Respondent.** | **ORDER INSTITUTING PUBLIC ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER** |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted against Peter Messineo ("Messineo") and Messineo & Co., CPAs, LLC ("Messineo & Co.") (together, "Respondents") pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934

[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

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("Exchange Act") and Rule 102(e)(1)(ii) and 102(e)(1)(iii) of the Commission's Rules of Practice.[2]

## II.

In anticipation of the institution of these proceedings, Respondents have submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or 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, and except as provided herein in Section V, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

## III.

On the basis of this Order and Respondents' Offer, the Commission finds[3] that:

### A. SUMMARY

Messineo & Co. is a small, Florida-based accounting firm. Among other things, it has performed audits of public companies whose stock is registered with the Commission and who file audited financial statements with the Commission. Messineo is a partner at and majority owner of Messineo & Co. Messineo & Co. and Messineo performed deficient audits of public company clients, which caused those clients to file misleading audited financial statements with the Commission. To cover up their deficiencies, certain employees of Messineo & Co. backdated and falsified its audit documentation. Messineo also performed sub-standard engagement quality reviews for another auditor. In late 2012, Messineo effectively merged his

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2 Rule 102(e)(1)(ii) provides, in pertinent part, that:

> The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct.

Rule 102(e)(1)(iii) provides, in pertinent part, that:

> The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found...to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

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

firm with another firm to form DKM Certified Public Accountants, Inc. ("DKM"). The merger exacerbated Respondents' on-going violations of the independence rules for accountants involving DKM's clients and Messineo. Prior to the merger, Messineo had been the chief financial officer ("CFO") of two of DKM's clients and concurrently the employer of a partner on DKM's audit engagement team. After the merger, Messineo was a shareholder of two of DKM's clients and DKM was auditing Messineo's work. Lastly, Messineo failed to timely file with the Commission Forms 3, 4, or 5 and Schedule 13Ds detailing his beneficial ownership of stock in these audit clients.

As a result, Messineo & Co. and Messineo violated auditing standards and independence rules, caused issuers to file misstatements, and failed to disclose his beneficial ownership. In addition, Messineo falsely certified annual and quarterly reports as chief financial officer of two issuers. Respondents' conduct violated the Federal securities laws and the rules and regulations thereunder. Respondents' conduct was willful and constitutes improper professional conduct.

## B. RESPONDENTS

**Messineo & Co., CPAs, LLC ("Messineo & Co.")** is registered with the Public Company Accounting Oversight Board ("PCAOB") as a public accounting firm based in Clearwater, Florida. The limited liability company operated as a sole proprietorship under the name Peter Messineo, CPA from 2009 until December 17, 2012, when it effectively merged with Drake & Klein, CPAs PA ("Drake & Klein") to form DKM Certified Public Accountants, Inc. ("DKM"). Peter Messineo separated from DKM in April 2013 and began operating Messineo & Co. again, but under its present name and form. During 2012, Messineo & Co. performed audit services for over 70 clients, but only had one partner -- sole owner Peter Messineo -- authorized to sign or issue audit reports. In 2012, Messineo & Co. employed Robin Bigalke and Richard Confessore and paid Joseph E. Mohr to perform engagement quality reviews ("EQRs").

**Peter Messineo**, age 54, resides in Palm Harbor, Florida and is currently a partner at and 95% owner of Messineo & Co. In 2012, he was the sole owner of Messineo & Co. (then named "Peter Messineo, CPA") and CFO of Issuer A and Issuer B (described below). From December 17, 2012 to April 16, 2013, Messineo was a partner and one third owner of DKM and a shareholder of Issuer A and Issuer B stock. Messineo has been licensed as a certified public accountant ("CPA") in New York since 1989 and in Florida since 2007.

## C. OTHER RELEVANT PARTIES

**DKM Certified Public Accountants, Inc. ("DKM")** is a PCAOB-registered public accounting firm based in Clearwater, Florida. DKM is a Florida corporation and successor to audit firms: (i) Drake Klein & Messineo CPAs PA and (ii) Drake & Klein. In December 2012, when Peter Messineo joined DKM, the firm changed its operational name from Drake & Klein to DKM. From December 2012 through April 2013, DKM had four partners authorized to issue audit reports on behalf of the firm, including: Messineo, Confessore, and Charles Klein.

**Ronald R. Chadwick, P.C. ("Chadwick")** was a PCAOB-registered public accounting firm based in Aurora, CO. From at least September 2010 through October 2013, Messineo performed engagement quality reviews of audits conducted by Chadwick. In April 2015, the PCAOB revoked Chadwick's registration and has barred Mr. Ronald Chadwick from being an associated person of a registered public accounting firm. The PCAOB imposed those sanctions on the basis of its findings of violations of the PCAOB's rules and auditing standards in connection with the audits of financial statements of five issuer clients for which Messineo provided the engagement quality review.

**Richard Confessore**, age 73, resides in Sarasota, Florida and has been a licensed CPA in Florida since 1970. Confessore is currently a "Quality Review Partner" at DKM. During 2011, Confessore was the CFO and worked at Issuer C Corporation. During 2012-2013, Confessore performed engagement quality reviews for the annual audits and interim reviews DKM performed for Issuers A and B. In addition, from June 2012 – December 2012, Confessore was an employee for Messineo & Co, then a sole proprietorship owned by Peter Messineo.

**Charles U. Klein**, age 60, resides in Dunedin, Florida and is currently President of DKM. From approximately February 2012 through June 2013, Klein was the lead engagement partner for the services DKM performed for Issuer A and Issuer B, including annual audits and interim reviews of Issuer B's and Issuer A's financial statements. Klein has been a licensed CPA in Florida since 1985, excluding 1995 to 1998 when his license was inactive.

**Joseph E. Mohr**, age 49, resides in Spring Hill, Florida and is currently an assistant professor at a Florida university. From 2009 through 2012, Messineo & Co. hired Mohr to perform EQRs. At the time, Mohr lived and worked in Florida, but was not licensed as a CPA in Florida or in any other state.

**Issuer A** was incorporated in Delaware in 2005 and is currently headquartered in California. During 2012 and 2013, Issuer A's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. In its most recent Form 10-K filed with the Commission, Issuer A states that its business offers marketing tools and expertise to advertisers. From February 2010 through November 2012, Messineo served as CFO of Issuer A. In 2012 and 2013, Issuer A engaged Drake & Klein and then DKM to perform audit services.

**Issuer B** was incorporated in Nevada in 2004 and is currently headquartered in St. Petersburg, FL. During 2012 and 2013, Issuer B's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. In its most recent Form 10-K filed with the Commission, Issuer B states that its business "creates a unified solution path to securely manage Advanced Metering Infrastructure and other Smart Grid optimization applications such as substation and distribution automation." From September 2010 through October 2012, Messineo served as CFO of Issuer B. In 2012 and 2013, Issuer B engaged Drake & Klein and then DKM to perform audit services.

**Issuer C** was incorporated in Colorado in 1981. Currently, it is a Florida corporation headquartered in Southbury, CT. During 2012 and 2013, Issuer C's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. In its most recent Form 10-K filed with the Commission, Issuer C states that its business consists of "operating motor freight carriers, providing truck load service throughout the forty-eight contiguous United States." Confessore resigned as CFO of Issuer C on April 12, 2011. In 2012, Issuer C engaged Messineo & Co. to provide audit services. Messineo & Co. did not complete its audit or issue an audit report before the formation of DKM. In 2013, Issuer C engaged DKM to provide audit services for the same period for which Messineo & Co. had been engaged.

## D. MESSINEO & CO. AND MESSINEO ENGAGED IN IMPROPER PROFESSIONAL CONDUCT BY CONDUCTING AUDITS AND REVIEWS NOT IN ACCORDANCE WITH PCAOB STANDARDS.

1. During 2011 and 2012, Messineo & Co. -- at Messineo's direction -- issued audit reports to at least 13 issuers without first obtaining the required engagement quality review ("EQR") and concurring approval in violation of PCAOB auditing standards.

2. PCAOB Auditing Standard No. 7 (*Engagement Quality Review*) ("AS 7") enumerates the standards for an EQR or concurring review. An EQR is required for every audit of an annual report and review of interim financial information for a quarterly report. *See* PCAOB AS 7.1.

3. PCAOB AS 7 provides that "[i]n an audit, the firm may grant permission to the client to use the engagement report only after the engagement quality reviewer provides concurring approval of issuance" and "[i]n a review of interim financial information, the firm may grant permission to the client to use the engagement report (or communicate an engagement conclusion to its client, if no report is issued) only after the engagement quality reviewer provides concurring approval of issuance." *See* PCAOB AS 7.13 and AS 7.18.

4. For some of the 13 engagements, Messineo requested an EQR from Joseph Mohr after he had already issued the audit report. For other engagements, Messineo requested the EQR before he issued the audit report, but failed to wait for Mohr to respond before issuing the audit report and granting permission to use it.

5. For at least one engagement, Messineo & Co. issued an audit report without even soliciting an EQR because it erroneously deemed EQRs "unnecessary" for clients who were "blank check" companies.

6. By issuing audit reports to the 13 issuers without an EQR and concurring approval, Messineo & Co. violated PCAOB standards. *See* PCAOB AS 7.

## E. RESPONDENTS VIOLATED RULE 2-02 OF REGULATION S-X BECAUSE MESSINEO & CO'S AUDIT REPORTS DID NOT COMPLY WITH PCAOB STANDARDS.

7. Rule 2-02(b)(1) of Regulation S-X (*Representations as to the Audit included in Accountants' Reports*) requires an accountant's report to state "whether the audit was made in accordance with generally accepted auditing standards." 17 CFR §210.2-02(b). These standards include the standards of the PCAOB. "[R]eferences in Commission rules and staff guidance and in the federal securities laws to [generally accepted auditing standards "GAAS"] or to specific standards under GAAS, as they related to issuers, should be understood to mean the standards of the PCAOB plus any applicable rules of the Commission." *See* SEC Release No. 34-49708.

8. Messineo & Co.'s audit reports for each of these 13 engagements inaccurately stated that Messineo & Co. had "conducted [its] audit in accordance with the standards of the Public Company Accounting Oversight Board (United States)."

9. In fact, Messineo & Co.'s audits were not conducted in accordance with PCAOB auditing standards because they lacked an EQR and concurring approval of issuance. *See* PCAOB AS 7.1 and AS 7.13.

10. Accordingly, Messineo & Co. violated and Messineo aided and abetted and caused a violation of Rule 2-02 of Regulation S-X.

## F. RESPONDENTS' CONDUCT CAUSED VIOLATIONS OF EXCHANGE ACT SECTIONS 13(a) AND 15(d) AND RULES 13a-1 AND 15d-1 THEREUNDER.

11. Exchange Act Sections 13(a) and 15(d) and Rules 13a-1 and 15d-1 require an issuer to file accurate annual reports on Form 10-K.

12. As detailed above, Messineo & Co. and Messineo issued false audit reports to at least 13 issuers because they lacked an EQR and concurring approval of issuance. Twelve of the 13 issuers were required to file annual statements under Sections 13(a) and 15(d). In accordance with Messineo & Co.'s and Messineo's expectations, the 12 issuers incorporated the false audit reports into their respective annual reports (Form 10-Ks) filed with the Commission. As a result, the issuers' annual reports contained material misstatements because they included false audit reports that lacked an EQR and concurring approval of issuance.

13. Messineo & Co. and Messineo, therefore, caused at least 12 different issuers to violate Sections 13(a) and 15(d) of the Exchange Act and Rules 13a-1 and 15d-1 thereunder.

## G. RESPONDENTS ENGAGED IN IMPROPER PROFESSIONAL CONDUCT BY FALSIFYING RECORDS AND BACKDATING DOCUMENTS.

14. The PCAOB had issued an inspection report to Messineo & Co. in April 2012 and notified Messineo that it was going to conduct another inspection approximately 12 months following its report.

15. In August 2012, Messineo directed Messineo & Co. personnel to review its audit files to identify and correct deficiencies in its audit documentation. Because Messineo had issued engagement reports without concurring approval, deficiencies existed in Messineo & Co.'s EQR documentation.

16. PCAOB Auditing Standard No. 7 requires that documentation of an EQR should "contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer…to comply with the provisions of this standard, including information that identifies:

* * *

> c. The date the engagement quality reviewer provided concurring approval of issuance or, if no concurring approval of issuance was provided, the reasons for not providing the approval.

*See* PCAOB AS 7.19.

17. PCAOB AS 7 also states that "[d]ocumentation of an engagement quality review should be included in the engagement documentation" and that "[t]he requirements related to retention of and subsequent changes to audit documentation in PCAOB Auditing Standard No. 3, Audit Documentation, apply with respect to the documentation of the engagement quality review." *See* PCAOB AS 7.20 and 7.21.

18. PCAOB Auditing Standard No. 3 (*Audit Documentation*) ("AS 3") provides the requirements for documentation an auditor should prepare and retain for engagements. Per PCAOB AS 3, audit documentation must document the nature, timing, and results of the procedures performed. *See* PCAOB AS 3.6.

19. PCAOB AS 3 requires an auditor to assemble a complete and final set of audit documentation no more than 45 days after the report release date ("documentation completion date"). Audit documentation may not be deleted or discarded following the documentation completion date. PCAOB AS 3 mandates that any documentation added after the document completion date "must indicate the date the information was added, the name of the person who prepared the additional documentation, and the reason for adding it." *See* PCAOB AS 3.15 and AS 3.16.

20. To document EQRs, Messineo & Co. used a "Concurring Review Questionnaire," otherwise known as a "Form 4.2."

21. After completing an EQR, the engagement quality reviewer–typically Mohr–was supposed to answer the questions on the Concurring Review Questionnaire and then sign and date the Questionnaire. The date on the form was to indicate when Mohr provided concurring approval of the issuance of the audit report. Messineo had no other system of tracking when Mohr completed an EQR other than the Form 4.2.

22. Mohr then emailed the signed forms to Messineo & Co. where the executed Concurring Review Questionnaires were included within the firm's audit files.

23. Beginning in August 2012, Messineo & Co. identified many engagements for which either:

   a. it was missing a Concurring Review Questionnaire signed by Mohr; or

   b. the signed Concurring Review Questionnaire was dated after the audit report had been issued by Messineo & Co., indicating that Messineo & Co. had issued the audit report prior to Mohr's completion of his EQR.

24. As a result, Messineo & Co. personnel under Messineo's general supervision requested Mohr backdate his signature on Concurring Review Questionnaires for multiple public company audit clients.

25. Mohr complied with many–if not all–of Messineo & Co.'s requests. He knowingly misrepresented the dates that he completed his EQRs.

26. Messineo & Co. personnel then inserted the backdated Concurring Review Questionnaires into Messineo & Co.'s audit files, including into files which should have been–pursuant to auditing standards–closed because the audit report had been issued more than 45 days earlier.

27. In addition, in connection with audits of two clients, Messineo & Co. personnel completed at some time various audit checklists and forms, including "Audit Documentation Checklists" and "Supervision, Review, and Approval Forms."

28. On the forms, Messineo & Co.'s audit manager signed Peter Messineo's name and initials on his behalf thereby certifying that the EQRs for those two audits were timely and adequately performed and that the audit files contained documentation of the EQRs. Those representations were false. As of the date indicated on the respective forms, Mohr had not performed the EQRs for those two audits. These false documents were included within Messineo & Co.'s audit files.

29. The backdating and falsification of audit documentation and the insertion of the false documents into Messineo & Co.'s audit files constitutes violations of PCAOB AS 3 and PCAOB AU 230 (*Due Professional Care in the Performance of Work*).

30. PCAOB Interim Auditing Standard AU 230 "requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting." *See* PCAOB AU 230.02.

## H. MESSINEO ENGAGED IN IMPROPER PROFESSIONAL CONDUCT WHEN HE CONDUCTED ENGAGEMENT QUALITY REVIEWS FOR AN ANOTHER AUDITOR IN CONTRAVENTION OF PCAOB STANDARDS.

31. From approximately September 2010 until October 2013, Messineo functioned as Ronald Chadwick's engagement quality reviewer. He consented to the issuance of over 130 audit reports for over 80 different Chadwick issuer clients during that period. For at least 5 of these engagements, Messineo conducted substandard reviews.

32. PCAOB AS 7 requires that "an engagement quality reviewer must have competence, independence, integrity, and objectivity." *See* PCAOB AS 7.4.

33. Per PCAOB AS 7, in an audit the engagement quality reviewer should review engagement documentation, and specifically "should":

* * *

> 10(g). Read other information in documents containing the financial statements to be filed with the Securities and Exchange Commission ("SEC") and evaluate whether the engagement team has taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact of which the engagement quality reviewer is aware.

*See* PCAOB AS 7.10.

34. To conduct the EQRs, Messineo relied upon Chadwick to provide him with audit materials and documents. But Chadwick did not provide him with the requisite documentation for Messineo to conduct a proper EQR.

35. For example, for at least five reviews, Chadwick failed to provide a complete draft filing (Form 10-K, Form S-1, etc.) for Messineo's review. While Messineo may have reviewed some form of the financial statements, Messineo did not read -- as required

by PCAOB AS 7 -- the information in documents containing the financial statements that were to be filed with the Commission prior to issuing his EQR. Nor could he evaluate whether Chadwick had taken appropriate action with respect to any material inconsistencies with the financial statements or material misstatements of fact.

36. Despite lacking sufficient documentation to conduct a proper EQR, Messineo approved Chadwick's issuance of the audit reports in violation of PCAOB auditing standards. *See* PCAOB AS 7.

## I. AS CHIEF FINANCIAL OFFICER OF ISSUER A AND ISSUER B, MESSINEO FALSELY CERTIFIED THEIR ANNUAL AND QUARTERLY REPORTS IN 2012 IN VIOLATION OF SECTION 13(a) OF THE EXCHANGE ACT AND RULE 13a-14 THEREUNDER AND AIDED AND ABETTED AND CAUSED ISSUER A AND ISSUER B TO VIOLATE SECTION 13(a) OF THE EXCHANGE ACT AND RULES 13a-1 AND 13a-13 THEREUNDER.

37. As Chief Financial Officer of Issuer A, Messineo provided certifications included with Issuer A's Forms 10-Qs for the quarters ending June 30, 2012 (filed August 14, 2012) and September 30, 2012 (filed November 14, 2012).

38. As Chief Financial Officer of Issuer B, Messineo provided certifications included with Issuer B's Form 10-K for the annual period ending June 30, 2012 (filed October 15, 2012) and its amended Form 10-K filed October 22, 2012 covering the same period.

39. With respect to each report, Messineo certified that:

- "Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report."

40. Messineo provided certifications for Issuer A and Issuer B pursuant to Rule 13a-14 under the Exchange Act.

41. Rule 13a-14(a) under the Exchange Act requires the principal financial officer to certify that, based on his knowledge, the Form 10-K or 10-Q submitted to the Commission by the issuer "does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading...." 17 CFR §240.13a-14(a).

42. Messineo's certifications were false because Messineo knew that Issuer A's and Issuer B's auditor, DKM, was not independent as required by Section 13(a) of the Exchange Act and Rule 10-01(d) of Regulation S-X. *See* Exchange Act Section 13(a) (requiring issuers to file annual reports certified by "independent public accountants"); 17 CFR §210.10-01(d) (requiring that prior to filing, interim financial statements included in quarterly reports on Form 10-Q "must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews…."). An auditor's lack of independence is a material fact.

43. DKM lacked independence because the engagement quality reviewer at DKM for the Issuer A and Issuer B engagements -- Richard Confessore -- concurrently maintained a prohibited business relationship with Messineo.

44. Rule 2-01(b) of Regulation S-X (*Qualifications of Accountants*) states that the "Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not…capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement." 17 CFR §210.2-01.

45. Rule 2-01(c) (3) states certain "business relationships" are inconsistent with independence:

> *Business Relationships.* An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders.

17 CFR §210.2-01(c)(3)

46. Rule 2-01(f)(11) defines "covered person" to include partners, principals, shareholders, and employees of an accounting firm on the "audit engagement team." 17 CFR §210.2-01(f)(11). The "audit engagement team" includes the "concurring or reviewing partner." 17 CFR §210.2-01(f)(7)(ii)(B).

47. PCAOB standards also require auditor independence. PCAOB Rule 3520 (*Auditor Independence*) requires that, "[a] registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period."

48. PCAOB AS 7 requires that "an engagement quality reviewer must have competence, independence, integrity, and objectivity." *See* PCAOB AS 7.4.

49. In June 2012, Messineo hired Confessore to work for him at Messineo & Co. Confessore worked at Messineo & Co. until mid-December 2012. Thus, at the same time Confessore conducted engagement quality reviews for DKM's reviews of Issuer A's interim financial statements filed August 14, 2012 and November 14, 2012 and for DKM's audit of Issuer B's annual financial statements filed October 15, 2012 and amended October 22, 2012, Confessore worked under Messineo -- the Chief Financial Officer of both Issuer A and Issuer B. Confessore's employment with Messineo constitutes an improper business relationship and conflict of interest.

50. As an auditor subject to independence rules, Messineo knew or should have known that the audits and reviews being performed by DKM with Confessore as the engagement quality reviewer violated the independence rules and relevant professional standards.

51. Despite Confessore's and, therefore, DKM's lack of independence, DKM issued an audit report to Issuer B falsely stating that its audit was performed in accordance with PCAOB standards.

52. Despite knowing Confessore and DKM lacked independence, Messineo still certified Issuer A's quarterly reports and Issuer B's annual report and amended annual report in violation of Rule 13a-14.

53. Messineo signed and approved for filing Issuer B's annual report even though it included DKM's false audit report and had not been certified by an independent public accountant. He signed and approved for filing Issuer A's quarterly reports even though Issuer A's interim financial statements had not previously been reviewed by an independent public accountant

54. Therefore, Messineo aided and abetted and caused Issuer A's and Issuer B's violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 promulgated thereunder.

## J. IN 2013, MESSINEO CAUSED DKM NOT TO BE INDPENDENT BY POSSESSING A DIRECT FINANCIAL INTEREST IN DKM'S AUDIT CLIENTS ISSUER A AND ISSUER B.

55. Messineo resigned as Issuer B's Chief Financial Officer effective October 30, 2012 and Issuer A's Chief Financial Officer effective November 15, 2012.

56. In mid-December 2012, Messineo joined DKM. Messineo was a partner and one-third owner of DKM.

57. Issuer A engaged DKM to perform audit services for the annual period ending December 31, 2012 (Form 10-K filed April 15, 2013). Issuer B engaged DKM to

perform a review for the quarter ending December 31, 2012 (Form 10-Q filed February 19, 2013).

58. Charles Klein continued to be DKM's lead partner for the Issuer A and Issuer B engagements and Confessore continued as the engagement quality reviewer. DKM continued to lack independence from Issuer A and Issuer B because Messineo owned stock in both companies during the audit and professional engagement periods.

59. Rule 2-01(c)(1) (*Financial Relationships*) states that an accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a "direct financial interest" in the accountant's audit client, including when:

> A. The accounting firm [or] any covered person in the firm...has any direct investment in an audit client, such as stocks, bonds, notes, options, or other securities.
>
> * * *
>
> B. Any partner, principal, shareholder, or professional employee of the accounting firm...has filed a Schedule 13D...with the Commission indicating beneficial ownership of more than five percent of an audit client's securities.

17 C.F.R. §210.2-01(c)(1)(i)(A)-(B)

60. Rule 2-01(f)(11) defines "covered person" to include any "other partner, principal, or shareholder from an 'office' of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit." 17 CFR §210.2-01(f)(11). "Office" means "a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines." 17 CFR §210.2-01(f)(15).

61. During the professional engagement periods of DKM's audit of Issuer A and interim review of Issuer B from January through April 2013, Messineo -- a DKM partner working in the same small office as Klein -- owned stock in DKM's clients Issuer A and Issuer B. As of April 15, 2013, when Issuer A's Form 10-K was filed, Messineo owned approximately 6% of the outstanding stock of Issuer A.

62. DKM was, therefore, not independent of its clients Issuer A and Issuer B with respect to DKM's audit and interim review of their public filings made in February 2013 and April 2013, respectively, because Messineo possessed a direct financial interest (stock ownership) in those companies during DKM's professional engagement periods. *See* Regulation S-X Rule 2-01(c)(1).

## K. IN 2013, MESSINEO CAUSED DKM NOT TO BE INDEPENDENT BECAUSE HE WAS AN OFFICER OF DKM'S AUDIT CLIENTS ISSUER A AND ISSUER B DURING THEIR RESPECTIVE AUDIT PERIODS.

63. Rule 2-01(c)(2) (*Employment Relationships*) states that an accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an "employment relationship" with an audit client, including when:

> A former officer, director, or employee of an audit client becomes a partner, principal, shareholder, or professional employee of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit covering any period during which he or she was employed by or associated with that audit client.

17 CFR §210.2-01(c)(2)(iv) (*Employment at Accounting Firm of Former Employee of Audit Client*).

64. From at least January 2013 through April 2013, Messineo had space at DKM's small office in Clearwater, Florida along with Charles Klein and approximately 6-8 staff personnel. Messineo's office was less than 10 feet away from the offices of those providing audit services to Issuer A and Issuer B.

65. From December 2012 through April 2013, Messineo had access to all of DKM's audit files, including those for the audit of Issuer A and the interim review of Issuer B. Messineo supervised the audit staff at DKM, including the audit manager who worked on the Issuer A audit, in some of DKM's other engagements.

66. During a significant portion of the professional engagement period for DKM's audit of Issuer A, Messineo possessed Issuer A's books and records.

67. DKM was, therefore, not independent of its clients Issuer A and Issuer B with respect to DKM's audit and interim review of their financial statements made in February 2013 and April 2013 because Messineo -- a partner and shareholder of DKM -- was the CFO of Issuer A and Issuer B during the audit period and in a position to influence DKM's audit and interim reviews. *See* Regulation S-X Rule 2-01(c)(2).

## L. MESSINEO CAUSED DKM NOT TO BE INDEPENDENT BY EMPLOYING ISSUER C'S FORMER CFO TO AUDIT ISSUER C FOR THE PERIOD HE WAS CFO.

68. Confessore was the CFO of Issuer C until April 12, 2011. Following his resignation, Confessore made himself available to Issuer C on a part-time basis to assist with accounting matters. On June 29, 2011, Issuer C filed a "Notification of Late Filing"

for its Form 10-K. The notification explained that Issuer C was unable to complete its accounting at the subsidiary level. Issuer C's notification identified Confessore as the person to contact in regard to the notification.

69. In 2012, Issuer C engaged Messineo & Co. to perform audit services. Messineo employed Confessore to participate in the year-end March 31, 2012 audit of Issuer C even though Confessore had been CFO and worked for Issuer C during the audit period. As a result, Messineo & Co. was not independent of its client Issuer C.

70. In June 2013, DKM issued an audit report for Issuer C's financial statements for the period from April 1, 2011 to March 31, 2012. Prior to his departure from DKM in April 2013, Messineo was the partner responsible for the engagement and allowed Confessore to participate despite his prior employment with Issuer C.

71. As a result of Messineo's action, DKM was not independent of Issuer C with respect to its public filings made in June 2013 because Confessore -- a partner of DKM -- was the CFO of Issuer C during the audit period and participated in the audit. *See* Regulation S-X Rule 2-01(c)(2).

## M. MESSINEO VIOLATED SECTIONS 13(d) AND 16(a) OF THE EXCHANGE ACT AND RULES 13d-1, 13d-2, AND 16a-3 THEREUNDER WHEN HE FAILED TO TIMELY FILE REQUIRED OWNERSHIP DISCLOSURES.

72. Messineo failed to file required Commission ownership disclosures, including Forms 3, 4, and 5 and Schedule 13Ds, concerning stock ownership in Issuer A and Issuer B, within the time period required.

73. Section 13(d) of the Exchange Act states:

> (1) Any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class which is registered pursuant to section 12 of this title..., is directly or indirectly the beneficial owner of more than 5 per centum of such class shall, within ten days after such acquisition...file with the Commission, a statement containing such of the following information...."
>
> (2) If any material change occurs in the facts set forth in the statement filed with the Commission, an amendment shall be filed with the Commission...."

74. Rule 13d-1 (*Filing of Schedule 13D and 13G*) requires that a person satisfy his obligations to file statements with the Commission under Section 13(d) by filing a Schedule 13D or 13G.

75. Rule 13d-2 (*Filing of Amendments to Schedules 13D or 13G*) directs that:

> (a) If any material change occurs in the facts set forth in the Schedule 13D... including, but not limited to, any material increase of decrease in the percentage of the class beneficially owned, the person or persons who were required to file the statement shall promptly file or cause to be filed with the Commission an amendment disclosing that change.
>
> * * *
>
> [Any change] equal to one percent or more...shall be deemed "material" for purposes of this rule....

76. Section 16(a) of the Exchange Act requires that every officer, director, or beneficial owner of more than 10% of stock file with the Commission statements disclosing their holdings and transactions of any stock of the issuer.

77. The statements shall be filed "within 10 days after he or she becomes such beneficial owner, director, or officer...." Statements shall also be filed for any change in such ownership "before the end of the second business day following the day on which the subject transaction has been executed...."

78. Rule 16a-3 (*Reporting Transactions and Holdings*) states that:

> (a) Initial statements of beneficial ownership of equity securities required by Section 16(a) of the Act shall be filed on Form 3. Statements of changes in beneficial ownership required by that section shall be filed on Form 4. Annual statements shall be filed on Form 5.
>
> * * *
>
> (f)(1) A Form 5 shall be filed by every person who at any time during the issuer's fiscal year was subject to section 1 of the Act...[and] shall be filed within 45 days after the issuer's fiscal year end, and shall disclose the following holdings and transactions not reported previously on Forms 3, 4 or 5:
>
> * * *
>
> (iii) all holdings and transactions that should have been reported during the most recent fiscal year, but were not...

79. A Form 4 must be filed to report new acquisitions, and must be "filed before the end of the second business day following the day on which the subject transaction had been executed. *See* Rule 16a-3(g)(1).

80. In January 2010, Messineo first acquired shares in Issuer A. The following month, February 2010, he became Issuer A's CFO. Within 10 days of becoming CFO, Messineo was obligated to file a Form 3 disclosing his ownership of Issuer A stock. See Section 16(a) of the Exchange Act; *see also* Rule 16a-3. Messineo failed to do so. Instead, Messineo filed an erroneous Form 3 over three years late in 2013, after he had resigned as CFO.

81. Messineo acquired 2,000,000 and 70,000,000 shares of Issuer A stock on December 28, 2010 and December 28, 2011, respectively. Messineo failed to file Form 4s after acquiring the stock or Form 5s for either FY 2010 or 2011 listing all holdings and transactions that should have been reported previously on Forms 3 and 4. *See* Section 16(a) of the Exchange Act and Rule 16a-3 thereunder.

82. By March 2011, Messineo owned 12% of Issuer A's outstanding stock, and by March 2012 Messineo's ownership share surpassed 30%. Yet, Messineo never filed a Schedule 13D with the Commission or any subsequent amendment disclosing his greater than 5% beneficial ownership. *See* Section 13(d) of the Exchange Act and Rules 13d-1 and 13d-2 thereunder.

83. Messineo became CFO of Issuer B in September 2010 and resigned as Issuer B's CFO effective October 30, 2012. Messineo acquired Issuer B stock on November 11, 2010. Messineo has never filed a Form 3, Form 4, or Form 5 with the Commission in connection with his ownership of Issuer B stock in violation of the securities laws. *See* Section 16(a) of the Exchange Act and Rule 16a-3 thereunder.

## N. VIOLATIONS

84. As a result of the conduct described above, Messineo & Co. and Messineo engaged in improper professional conduct as defined in Rule 102(e)(1)(iv). Messineo & Co. and Messineo committed intentional and knowing conduct that resulted in violations of applicable professional standards and committed repeated instances of highly unreasonable negligent conduct each resulting in violations of applicable professional standards that indicate a lack of competence to practice before the Commission.

85. As a result of the conduct described above, Messineo & Co. willfully violated and Messineo willfully aided and abetted and caused violations of Rule 2-02 of Regulation S-X.

86. As a result of the conduct described above, Messineo & Co. and Messineo aided and abetted and caused 12 of its clients to violate Section 13(a) of the Exchange Act and Rule 13a-1 thereunder or Section 15(d) of the Exchange Act and Rule 15d-1 thereunder.

87. As a result of the conduct described above, in his capacity as CFO Messineo willfully violated Rule 13a-14 promulgated under the Exchange Act.

88. As a result of the conduct described above, in his capacity as CFO Messineo willfully aided and abetted and caused Issuer B's violations of Section 13(a) of the Exchange Act and Rule 13a-1 and thereunder.

89. As a result of the conduct described above, in his capacity as CFO Messineo willfully aided and abetted and caused Issuer A's violations of Section 13(a) of the Exchange Act and Rule 13a-13 thereunder.

90. As a result of the conduct described above, Messineo willfully violated Sections 13(d) and 16(a) of the Exchange Act and Rules 13d-1, 13d-2, and 16a-3 thereunder.

## O. FINDINGS

91. Based on the foregoing, the Commission finds that Messineo & Co. and Messineo engaged in improper professional conduct pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

92. Based on the foregoing, the Commission finds that Messineo & Co. and Messineo willfully violated, or willfully aided and abetted the violation of, provisions of the Federal securities laws or the rules and regulations thereunder pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

93. Based on the foregoing, the Commission finds that Messineo: (a) willfully violated Sections 13(d) and 16(a) of the Exchange Act, Rules 13a-14, 13d-1, 13d-2, and 16a-3, (b) willfully aided and abetted and caused a violation of Rule 2-02 of Regulation S-X; (c) willfully aided and abetted and caused 12 audit clients' violations of Sections 13(a) and 15(d) of the Exchange Act and Rules 13a-1 and 15d-1 thereunder; and (d) caused Issuer A's and Issuer B's violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder.

94. Based on the foregoing, the Commission finds that Messineo & Co.: (a) willfully violated Rule 2-02 of Regulation S-X; and (b) willfully aided and abetted and caused 12 clients' violations of Sections 13(a) and 15(d) of the Exchange Act and Rules 13a-1 and 15d-1 thereunder.

## IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents Messineo & Co.'s and Messineo's Offer.

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

A. Respondents shall cease and desist from committing or causing any violations and any future violations of Sections 13(a), 13(d), 15(d) and 16(a) of the Exchange Act and Rules 13a-1, 13a-13, 13a-14, 13d-1, 13d-2, and 16a-3 thereunder and Rule 2-02 of Regulation S-X.

B. Respondents are denied the privilege of appearing or practicing before the Commission as accountants.

C. Respondents shall pay civil penalties of $25,000 to the Securities and Exchange Commission. Payment shall be made in the following installments:

Within 14 days of the issuance of the Order $10,000.00
Within 120 days of the issuance of the Order $5,000.00
Within 210 days of the issuance of the Order $5,000.00
Within 300 days of the issuance of the Order $5,000.00

If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to SEC Rule of Practice 600 shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

(1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondents 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) Respondents 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 Peter Messineo and/or Messineo & Co., CPAs, LLC as a Respondent(s) 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 John T. Dugan, Associate Regional Director, Boston regional Office, Securities and Exchange Commission, 33 Arch Street, Boston, MA 02110.

## V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Messineo, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Messineo of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
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. 76609 / December 10, 2015**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3723 / December 10, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16995**

| In the Matter of<br><br>RICHARD CONFESSORE, CPA<br><br>Respondent. | **ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTIONS 4C AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER** |
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## I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted against Richard Confessore ("Confessore") pursuant to Sections 4C[1] and 21C of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.[2]

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1 Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

2 Rule 102(e)(1)(ii) provides, in pertinent part, that:

> The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have engaged in unethical or improper professional conduct.

# II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement ("Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 4C and 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

# III.

On the basis of this Order and Respondent's Offer, the Commission finds[3] that:

## A. SUMMARY

Confessore violated the auditor independence rules for 7 audit and review engagements of three public company clients in 2012-2013 on account of employment, business, or financial relationships either he or his partners had with those three clients. In 2012, Confessore was the engagement quality review partner for DKM Certified Public Accountants, Inc.'s ("DKM's") audits or interim reviews of annual and quarterly financial statements of Issuer A and Issuer B. At the same time he performed this work, he worked for Issuer A's and B's Chief Financial Officer ("CFO"), Peter Messineo, at Messineo's own audit firm, Messineo & Co., CPAs, LLC ("Messineo & Co.").

Near the end of 2012, Messineo resigned as CFO of Issuer A and Issuer B and became a shareholder and partner at DKM. Despite Messineo joining DKM, Confessore continued in 2013 to conduct engagement quality reviews of financial statements of Issuer A and Issuer B for DKM even though: (1) the companies' former CFO was now his partner at DKM and in a position to influence the audits and reviews, and (2) Messineo had been CFO during the audit periods covered by his review. In addition, in 2013 when Confessore performed the engagement quality reviews for DKM

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Rule 102(e)(1)(iii) provides, in pertinent part, that:

> The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found...to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

3 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.

of Issuer A and Issuer B, he knew that Messineo -- his partner at DKM -- had a direct financial relationship with both Issuer A and Issuer B. Messineo owned stock in both companies.

Lastly, in 2013, DKM audited Issuer C's annual financial statement covering the period from April 1, 2011 – March 31, 2012. Confessore participated in the audit despite having served as Issuer C's CFO during the audit period.

Performing these audits and reviews for Issuer A, Issuer B, and Issuer C violated the independence rules of the Federal securities laws and the rules and regulations thereunder. Confessore also caused Issuer A, Issuer B, and Issuer C to file false or misleading reports with the Commission in violation of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 promulgated thereunder. Confessore's conduct was willful and constitutes improper professional conduct.

## B. RESPONDENT

**Richard Confessore**, age 73, resides in Sarasota, Florida and has been a licensed Certified Public Accountant ("CPA") in Florida since 1970. Confessore is currently a Director and "Quality Review Partner" at DKM. During 2011, Confessore was the CFO and worked at Issuer C. During 2012-2013, Confessore performed engagement quality reviews for the annual audits and interim reviews DKM performed for Issuers A and B. In addition, from June 2012 – December 2012, Confessore was an employee of Messineo & Co, then a sole proprietorship owned by Peter Messineo (who was also the CFO for both Issuer A and Issuer B).

## C. OTHER RELEVANT PARTIES

**Issuer A** was incorporated in Delaware in 2005 and is currently headquartered in California. During 2012 and 2013, Issuer A's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. In its most recent Form 10-K filed with the Commission, Issuer A states that its business "offers marketing tools and expertise to advertisers." From February 2010 – November 2012, Messineo served as CFO of Issuer A. In 2012 and 2013, Issuer A engaged DKM to perform audit services.

**Issuer B** was incorporated in Nevada in 2004 and is currently headquartered in St. Petersburg, FL. During 2012 and 2013, Issuer B's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. In its most recent Form 10-K filed with the Commission, Issuer B states that its business "creates a unified solution path to securely manage Advanced Metering Infrastructure and other Smart Grid optimization applications such as substation and distribution automation." From September 2010 – October 2012, Messineo served as CFO of Issuer B. In 2012 and 2013, Issuer B engaged DKM to perform audit services.

**Issuer C** was incorporated in Colorado in 1981. Currently, it is a Florida corporation headquartered in Southbury, CT. During 2012 and 2013, Issuer C's common stock was registered with the Commission pursuant to Section 12(g) of the Exchange Act. In its most recent Form 10-K filed with the Commission, Issuer C states that its business consists of "operating motor freight carriers, providing truck load service throughout the forty-eight contiguous United States."

Confessore resigned as CFO of Issuer C on April 12, 2011. In 2012, Issuer C engaged Messineo & Co to provide audit services. Messineo & Co. did not issue an audit report before DKM was formed. In 2013, Issuer C then engaged DKM to provide audit services for the same period for which Messineo & Co. had been retained.

**DKM Certified Public Accountants, Inc. ("DKM")** is registered with the Public Company Accounting Oversight Board ("PCAOB") as a public accounting firm based in Clearwater, Florida. DKM is a Florida corporation and successor to audit firms: (i) Drake Klein & Messineo CPAs PA; and (ii) Drake & Klein, CPAs PA ("Drake & Klein"). In December 2012, when Peter Messineo joined DKM, the firm changed its operational name from Drake & Klein to DKM. As of December 2012, DKM had four partners authorized to issue audit reports on behalf of the firm, including Messineo, Confessore, and Charles Klein.

**Charles U. Klein**, age 60, resides in Dunedin, Florida and is currently President of DKM. From approximately February 2012 through June 2013, Klein was the lead engagement partner for the services DKM performed for Issuer A, Issuer B, and Issuer C. These services included annual audits and interim reviews of the financial statements of Issuer A, Issuer B, and Issuer C. Klein has been a licensed CPA in Florida since 1985, excluding 1995 – 1998 when his license was inactive.

**Peter Messineo**, age 54, resides in Palm Harbor, Florida and is currently a partner at and 95% owner of Messineo & Co., which is a PCAOB-registered public accounting firm based in Clearwater, Florida. In 2012, he was the sole owner of Messineo & Co. (then named "Peter Messineo, CPA") and CFO of Issuer A and Issuer B. From December 17, 2012 – April 16, 2013, Messineo was a partner and one-third owner of DKM and a shareholder of Issuer A and Issuer B stock. Messineo has been licensed as a CPA in New York since 1989 and in Florida since 2007.

## D. IN 2012, CONFESSORE CAUSED DKM (THEN KNOWN AS DRAKE & KLEIN) NOT TO BE INDEPENDENT BY POSSESSING A BUSINESS RELATIONSHIP WITH THE CHIEF FINANCIAL OFFICER OF DKM'S AUDIT CLIENTS.

1. Issuer A engaged DKM to perform interim reviews for the quarters ending June 30, 2012 (Form 10-Q filed August 14, 2012) and September 30, 2012 (Form 10-Q filed November 14, 2012). Klein was DKM's lead engagement partner and Confessore was DKM's engagement quality review ("EQR") partner on these engagements.

2. During the audit and professional engagement periods for these Issuer A engagements, Messineo was Issuer A's CFO.

3. Issuer B engaged DKM to perform audit services for the annual period ending June 30, 2012 (Form 10-K filed October 15, 2012) and the quarter ending September 30, 2012 (Form 10-Q filed November 14, 2012). Klein was DKM's lead engagement partner and Confessore was DKM's EQR partner on these engagements.

4. During the audit and professional engagement periods for these Issuer B engagements, Messineo was Issuer B's CFO.

5. In June 2012, Messineo hired Confessore to work for him at Messineo & Co. Confessore worked at Messineo & Co. until mid-December 2012. Thus, Confessore worked under Messineo -- the Chief Financial Officer of both Issuer A and Issuer B -- at the same time Confessore conducted engagement quality reviews for DKM of: (i) Issuer A's interim financial statements filed August 14, 2012 and November 14, 2012; (ii) and Issuer B's annual financial statement filed October 15, 2012 (amended October 22, 2012). Confessore also worked for Messineo during the entire audit period of Issuer B's interim financial statements, filed November 14, 2012, which DKM and Confessore reviewed.

6. Rule 2-01(b) of Regulation S-X (*Qualifications of Accountants*) states that the "Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not...capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement." 17 CFR §210.2-01.

7. Rule 2-01(c) (3) states certain "business relationships" are inconsistent with independence:

> *Business Relationships.* An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client's officers, directors, or substantial stockholders.

17 CFR §210.2-01(c)(3).

8. Confessore's employment with Messineo constituted an improper business relationship and conflict of interest.

9. Rule 2-01(f)(11) defines "covered person" to include partners, principals, shareholders, and employees of an accounting firm on the "audit engagement team." 17 CFR §210.2-01(f)(11). The "audit engagement team" includes the "concurring or reviewing partner." 17 CFR §210.2-01(f)(7)(ii)(B).

10. PCAOB standards also require auditor independence. PCAOB Rule 3520 (*Auditor Independence*) requires that, "[a] registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period."

11. PCAOB Auditing Standard No. 7 (*Engagement Quality Review*) requires that "an engagement quality reviewer must have competence, independence, integrity, and objectivity." *See* PCAOB AS 7.4.

12. Confessore and DKM were not independent of Issuer A and Issuer B with respect to DKM's audit and interim reviews of financial statements filed from August 2012 through November 2012 because Confessore -- the engagement quality reviewer -- had a direct business relationship with Messineo -- the CFO of clients Issuer A and Issuer B -- during DKM's audit and professional engagement periods. *See* Rule 2-01(c)(3) of Regulation S-X; *see also* PCAOB AS 7 and PCAOB Rule 3520.

## E. IN 2013, CONFESSORE FAILED TO MAINTAIN PROFESSIONAL STANDARDS BY PERFORMING ENGAGEMENT QUALITY REVIEWS WHEN HE AND DKM LACKED INDEPENDENCE.

13. Messineo resigned as CFO of Issuer A effective November 15, 2012 and as CFO of Issuer B effective October 30, 2012.

14. In mid-December 2012, Messineo joined DKM. Messineo was a one-third owner of DKM. While not a shareholder, Confessore was a partner authorized to issue audit reports on behalf of DKM.

15. Issuer A engaged DKM to perform audit services for the annual period ending December 31, 2012 (Form 10-K filed April 15, 2013). Klein was DKM's lead engagement partner and Confessore was DKM's engagement quality review partner on this engagement.

16. Issuer B engaged DKM to perform interim review services for the quarter ending December 31, 2012 (Form 10-Q filed February 19, 2013). Klein was DKM's lead engagement partner and Confessore was DKM's engagement quality review partner on this engagement.

17. PCAOB AS 7 requires that "an engagement quality reviewer must have competence, <u>independence</u>, integrity, and objectivity." *See* PCAOB AS 7.4 (emphasis added).

18. Confessore lacked independence from Issuer A and Issuer B because Messineo, his partner at DKM, had financial and employment relationships with Issuer A and Issuer B.

19. Rule 2-01(c) (1) (*Financial Relationships*) states that an accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a "direct financial interest" in the accountant's audit client, including when:

    A. The accounting firm [or] any covered person in the firm...has any direct investment in an audit client, such as stocks, bonds, notes, options, or other securities.

* * *

> B. Any partner, principal, shareholder, or professional employee of the accounting firm...has filed a Schedule 13D...with the Commission indicating beneficial ownership of more than five percent of an audit client's securities

17 CFR §210.2-01(c)(1)(i)(A)-(B).

20. Rule 2-01(f)(11) defines "covered person" to include any "other partner, principal, or shareholder from an 'office' of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit." 17 CFR §210.2-01(f)(11). "Office" means "a distinct sub-group within an accounting firm, whether distinguished along geographic or practice lines." 17 CFR §210.2-01(f)(15).

21. Rule 2-01(c) (2) (*Employment Relationships*) states that an accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an "employment relationship" with an audit client, including when:

> A former officer, director, or employee of an audit client becomes a partner, principal, shareholder, or professional employee of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit covering any period during which he or she was employed by or associated with that audit client.

17 CFR §210.2-01(2)(iv) *Employment at Accounting Firm of Former Employee of Audit Client.*

22. From December 2012 to April 2013, Messineo worked at DKM's small office in Clearwater, Florida along with Klein and approximately 6-8 staff personnel. Messineo's office was less than 10 feet away from the offices of those providing audit services to Issuer A and Issuer B.

23. From December 2012 to April 2013, Messineo had access to all of DKM's audit files, including those for the audit of Issuer A and the interim review of Issuer B. Messineo supervised the audit staff at DKM, including the audit manager who worked on the Issuer A audit, in some of DKM's other engagements.

24. During a significant portion of the professional engagement period for DKM's audit of Issuer A, Messineo possessed Issuer A's books and records.

25. During Messineo's tenure as a shareholder and partner at DKM, he owned stock in DKM's clients Issuer A and Issuer B. As of April 15, 2013, when Issuer A's Form 10-K was filed, Messineo owned approximately 6% of the outstanding shares of Issuer A's stock.

26. Confessore knew Messineo owned stock in Issuer A and Issuer B during the audit and professional engagement periods for those clients. Despite his knowledge, he performed the EQR for DKM's audit of Issuer A and review of Issuer B without objection and consented to the issuance of DKM's audit report.

27. Confessore caused DKM to not be independent of Issuer A and Issuer B with respect to their public filings made in February 2013 and April 2013 because Messineo -- a partner and shareholder of DKM -- possessed a direct financial interest (stock ownership) in clients Issuer A and Issuer B during DKM's audit and professional engagement periods. *See* Rule 2-01(c)(1) of Regulation S-X; *see also* PCAOB AS 7.4.

28. Confessore caused DKM to not be independent of Issuer A and Issuer B with respect to their public filings made in February 2013 and April 2013 because Messineo -- a partner and shareholder of DKM -- was the CFO of Issuer A and Issuer B during the audit period and in a position to influence DKM's audit and interim review. *See* Rule 2-01(c)(2) of Regulation S-X; *see also* PCAOB AS 7.4.

## F. IN 2013, CONFESSORE CAUSED DKM NOT TO BE INDEPENDENT BY PARTICIPATING IN AN AUDIT OF HIS FORMER EMPLOYER.

29. Confessore was the CFO of Issuer C until April 12, 2011. Following his resignation, Confessore made himself available to Issuer C on a part-time basis to assist with accounting matters. On June 29, 2011, Issuer C filed a "Notification of Late Filing" for its Form 10-K. The notification explained that Issuer C was unable to complete its accounting at the subsidiary level. Issuer C's notification identified Confessore as the person to contact in regard to the notification.

30. In 2012, Issuer C engaged Messineo & Co. to perform audit services for the period from April 1, 2011 – March 31, 2012. Confessore performed work for Messineo & Co. concerning Issuer C, including the period for which he had been CFO and/or worked for Issuer C. Messineo & Co. did not complete its audit or issue an audit report before DKM was formed.

31. In 2013, DKM agreed to audit Issuer C's financial statements for the same period (April 1, 2011 – March 31, 2012) despite Confessore's prior position as CFO of Issuer C during that audit period. DKM incorporated Messineo & Co.'s work into its audit of Issuer C, including Confessore's work. On behalf of DKM, Klein signed the engagement report issued to Issuer C in June 2013.

32. Confessore caused DKM to not be independent of DKM's client Issuer C with respect to its public filings made in June 2013 because Confessore – a partner of DKM – participated in the audit of Issuer C, which covered the period Confessore had been the CFO and/or worked for Issuer C. *See* Rule 2-01(c)(2) of Regulation S-X.

33. Finally, Confessore failed to comply with PCAOB Interim Auditing Standard AU 230 (*Due Professional Care in the Performance of Work*). AU 230.02 "requires the independent auditor to plan and perform his or her work with due professional care. Due professional care imposes a responsibility upon each professional within an independent auditor's organization to observe the standards of field work and reporting." Confessore did not exercise due professional care when he performed EQRs while he lacked independence.

## G. CONFESSORE AIDED AND ABETTED AND CAUSED DKM TO VIOLATE RULE 2-02 OF REGULATION S-X BECAUSE DKM'S AUDIT REPORTS DID NOT COMPLY WITH PCAOB STANDARDS.

34. Rule 2-02(b)(1) of Regulation S-X (Representations as to the Audit included in Accountants' Reports) requires an accountant's report to state "whether the audit was made in accordance with generally accepted auditing standards." 17 CFR §210.2-02(b). These standards include the standards of the PCAOB. "[R]eferences in Commission rules and staff guidance and in the federal securities laws to [generally accepted auditing standards "GAAS"] or to specific standards under GAAS, as they related to issuers, should be understood to mean the standards of the PCAOB plus any applicable rules of the Commission." See SEC Release No. 34-49708.

35. DKM issued audit reports for its audits of Issuer C, Issuer A, and Issuer B for fiscal years ending March 31, 2012, December 31, 2012 and June 30, 2012, respectively. Confessore was the engagement quality review partner for these audits. The audit reports incorrectly state that DKM "conducted [its] audit in accordance with the standards of the Public Company Accounting Oversight Board (United States)."

36. DKM's audits were not conducted in accordance with PCAOB auditing standards because the firm lacked independence as described above. *See* PCAOB Rule 3520 (requiring independence); PCAOB AS 7.4 (same).

37. Accordingly, Confessore aided and abetted and caused violations of Rule 2-02 of Regulation S-X.

## H. CONFESSORE CAUSED ISSUER A, ISSUER B, AND ISSUER C TO FILE FALSE OR MISLEADING REPORTS WITH THE COMMISSION IN VIOLATION OF SECTION 13(a) OF THE EXCHANGE ACT AND RULES 13a-1 AND 13a-13 THEREUNDER.

38. Exchange Act Sections 13(a) and Rules 13a-1 and 13a-13 require an issuer to file accurate annual and quarterly reports on Forms 10-K and 10-Q. Section 13(a) of the Exchange Act also requires issuers file annual reports certified by "independent public accountants," and Rule 10-01(d) of Regulation S-X requires an "independent public accountant" review an issuer's interim financial statements before the issuer files its Form 10-Q.

39. As a result of Confessore's conduct, Issuer A, Issuer B, and Issuer C filed annual and quarterly reports which had not been audited or reviewed by independent accountants in violation of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13.

## I. VIOLATIONS

40. As a result of the conduct described above, Confessore willfully aided and abetted and caused (i) issuers to violate Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 promulgated thereunder, and (ii) DKM to violate Rule 2-02 of Regulation S-X.

41. As a result of the conduct described above, Confessore engaged in improper professional conduct as defined in Rule 102(e)(1)(iv) in that Confessore violated applicable professional standards or committed repeated instances of unreasonable negligent conduct each resulting in a violation of applicable professional standards that indicate a lack of competence to practice before the Commission.

## J. FINDINGS

42. Based on the foregoing, the Commission finds that Confessore engaged in improper professional conduct pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

43. Based on the foregoing, the Commission finds that Confessore willfully violated, or willfully aided and abetted the violation of, a provision(s) of the Federal securities laws or the rules and regulations thereunder pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

44. Based on the foregoing, the Commission finds that Confessore: willfully aided and abetted and caused issuers to violate Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 promulgated thereunder and DKM to violate Rule 2-02 of Regulation S-X.

## IV.

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

Accordingly, pursuant to Sections 4C and 21C of the Exchange Act, it is hereby ORDERED, effective immediately, that:

A. Confessore shall cease and desist from committing or causing any violations and any future violations of Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 promulgated thereunder, and Rule 2-02 of Regulation S-X.

B. Confessore is denied the privilege of appearing or practicing before the Commission as an accountant.

C. After 2 years from the date of this order, Confessore 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 Confessore'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) Confessore, 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) Confessore, 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 Confessore's or the firm's quality control system that would indicate that the Confessore's will not receive appropriate supervision;

   (c) Confessore 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) Confessore acknowledges his responsibility, as long as Confessore 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.

3. The Commission will consider an application by Respondent to resume appearing or practicing before the Commission provided that his CPA license is current and he has resolved all other disciplinary issues with the applicable boards of accountancy. However, if CPA licensure is dependent on reinstatement by the Commission, the Commission will consider an application on its own 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.

D. Confessore shall within 14 days of the entry of this Order, pay a civil money penalty in the amount of $15,000 to the Securities and Exchange Commission. 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 identifying Confessore 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 John T. Dugan, Associate Regional Director, Boston regional Office, Securities and Exchange Commission, 33 Arch Street, Boston, MA 02110.

By the Commission.

Brent J. Fields
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. 9985 / December 10, 2015

SECURITIES EXCHANGE ACT OF 1934
Release No. 76614 / December 10, 2015

Admin. Proc. File No. 3-16178

| In the Matter of<br><br>JOSEPH C. RUGGIERI | ORDER DENYING MOTION FOR SUMMARY AFFIRMANCE, GRANTING PETITIONS FOR REVIEW, AND SCHEDULING BRIEFS |
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On September 14, 2015, an administrative law judge issued an Initial Decision dismissing administrative proceedings against Joseph C. Ruggieri, a former trader at Wells Fargo Securities, LLC ("Wells Fargo").[1] The Division of Enforcement filed a petition for review of that decision. Ruggieri filed a cross-petition for review and a motion for summary affirmance of the Initial Decision. For the reasons below, we deny Ruggieri's motion for summary affirmance, grant the Division's petition and Ruggieri's cross-petition for review, and schedule the filing of briefs.

## I. Background

We instituted these proceedings on September 29, 2014, alleging that Ruggieri and Gregory T. Bolan, Jr., a colleague of Ruggieri's and research analyst at Wells Fargo, participated in an insider trading scheme in violation of the federal antifraud provisions.[2] After conducting a twelve-day hearing, the law judge issued a fifty-page initial decision dismissing the proceedings. The law judge found that, although the Division established that Ruggieri traded on tips he

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1 *Joseph C. Ruggieri*, Initial Decision Release No. 877, 2015 WL 5316569 (Sept. 14, 2015).

2 *Gregory T. Bolan, Jr.*, Exchange Act Release No. 73244, 2014 WL 4803778 (Sept. 29, 2014) (alleging violations of Securities Act Section 17(a), 15 U.S.C. § 77q(a); Securities Exchange Act Section 10(b), 15 U.S.C. § 78j(b); and Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5). The Commission accepted an offer of settlement with Bolan on May 28, 2015. *See Gregory T. Bolan, Jr.*, Exchange Act Release No. 75066, 2015 WL 3413279 (May 28, 2015) (making findings and imposing remedial sanctions and a cease-and-desist order).

received from Bolan, the Division did not satisfy its burden of establishing that Bolan tipped Ruggieri for a personal benefit within the meaning of *Dirks v. SEC*, 463 U.S. 646 (1983), and *United States v. Newman*, 773 F.3d 438 (2d Cir. 2014).[3]

On October 5, 2015, the Division filed a petition for review of the Initial Decision, asserting that the law judge erred in finding that Bolan did not tip Ruggieri for a personal benefit. The Division argues that the law judge's decision misapplied *Newman* and *Dirks* and drew "impermissible inferences" from the facts, "including that Bolan—risking his career—repeatedly tipped Ruggieri to valuable inside information without any expectation of receiving a benefit in return." Ruggieri filed a cross-petition for review on October 14, 2015, seeking review of the law judge's finding that Ruggieri was tipped about inside information and traded based on those tips. Ruggieri seeks review of those findings only if we grant the Division's petition for review.

On October 26, 2015, Ruggieri filed the present motion for summary affirmance, which the Division opposed.

## II. Analysis

Under Commission Rule of Practice 411(e)(2), we "will decline to grant summary affirmance upon a reasonable showing that . . . the decision embodies an exercise of discretion or decision of law or policy that is important and that the Commission should review." [4] We have previously observed that "[s]ummary affirmance is rare, given that generally we have an interest in articulating our views on important matters of public interest and the parties have a right to full consideration of those matters."[5]

Ruggieri argues that summary affirmance is appropriate because the Initial Decision rests on "a straightforward application of the facts to the well-settled insider trading law" and that, as a result, "there is no need for the Commission to consider additional oral or written argument." The Division disagrees, arguing that the conclusions in *Newman* "are unquestionably important to the developing law on personal benefit," and that, "the Commission should review the Initial Decision because no administrative law judge has applied or interpreted *Newman* before."

Based on our preliminary review of the record and the parties' submissions, we do not view summary affirmance as appropriate. This appeal raises issues as to which we have an interest in articulating our views and important matters of public interest, including insider trading law and the personal benefit requirement. We conclude that our consideration of the record and the parties' arguments would benefit from going through the normal appellate process rather than the abbreviated process involved with a summary affirmance. We accordingly deny

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3 *Ruggieri*, 2015 WL 5316569, at *1.

4 17 C.F.R. § 201.411(e)(2).

5 *Theodore W. Urban*, Order Denying Motion for Summary Affirmance, Securities Exchange Act Release No. 63456, 2010 SEC LEXIS 4054, at *6 (Dec. 7, 2010)

Ruggieri's motion.[6] Our denial of Ruggieri's motion should not be construed as suggesting any view about the merits of the case. We further grant the Division's petition and Ruggieri's cross-petition for review and schedule the filing of briefs.

* * * *

Accordingly, IT IS ORDERED that the motion for summary affirmance filed by Joseph C. Ruggieri is hereby denied; and it is further

ORDERED, pursuant to Rule of Practice 411,[7] that the Division of Enforcement's petition for review and Ruggieri's cross-petition for review are hereby granted; and it is further

ORDERED, pursuant to Rule of Practice 450(a),[8] that briefs be filed as follows:

Division's opening brief: The Division shall file a brief, not to exceed 14,000 words, by January 11, 2016.

Respondent's principal and response brief: Respondent shall file a brief, not to exceed 16,000 words, by February 10, 2016. This brief must address the issues presented by respondent's cross-petition for review and respond to the Division's opening brief.

Division's response and reply brief: The Division shall file a brief, not to exceed 9,000 words, by March 11, 2016.

Respondent's reply brief: Respondent may file a reply brief, not to exceed 7,000 words, by March 25, 2016. This brief must be limited to the issues presented by respondent's cross-petition for review.

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6 *See, e.g.*, *The Robare Group, Ltd.*, Exchange Act Release No. 75686, 2015 WL 4749145, at *2 (Aug. 12, 2015) (denying respondents' motion for summary affirmance and granting petition for review because of "the potentially important matters of public interest this case presents"); *David F. Bandimere*, Exchange Act Release No. 71333, 2014 WL 198175, at *3 (Jan. 16, 2014) (denying motion for summary affirmance and granting petition for review where "the submission of briefs, with discussion of relevant parts of the record and analysis of the issues, w[ould] aid . . . in reaching a decision in this case").

7 17 C.F.R. § 201.411.

8 *Id.* § 201.450(a).

As provided by Rule of Practice 450(a), no briefs except those specified in this schedule may be filed without leave of the Commission.[9] Pursuant to Rule of Practice 180(c), failure to file a brief in support of the petition or cross-petition for review may result in dismissal of this review proceeding as to that party.[10]

By the Commission.

Brent J. Fields
Secretary

Lynn M. Powalski

**By: Lynn M. Powalski**
**Deputy Secretary**

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[9] Attention is called to Rules of Practice 150 through 153, 17 C.F.R. §§ 201.150–153, with respect to form and service, and Rules of Practice 450(b) and (c), 17 C.F.R. § 201.450(b), 201.450(c), with respect to content and length limitations (except as modified in this order). The number of words includes any pleadings that are incorporated by reference.

[10] 17 C.F.R. § 201.411(a).

# UNITED STATES OF AMERICA
## Before the
## SECURITIES AND EXCHANGE COMMISSION

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76618 / December 11, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16998**

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| **In the Matter of**<br><br>**SMF Energy Corp.,**<br><br>**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 SMF Energy Corp. ("SMF" or "Respondent").

**II.**

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

## III.

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

A. SMF, a Delaware corporation headquartered in Fort Lauderdale, FL was a commercial mobile-fueling and lubricant distribution company. The common stock of SMF has been registered under Section 12(g) of the Exchange Act since December 1996. Until September 20, 2013, SMF stock was listed and traded on NASDAQ.

B. SMF has failed to comply with Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder, while its common stock was registered with the Commission in that it has not filed an Annual Report on Form 10-K since September 28, 2011 (as amended on October 28, 2011) or periodic or quarterly reports on Form 10-Q for any fiscal period subsequent to its fiscal quarter ending December 31, 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.

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

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.

Brent J. Fields
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. 9988 / December 11, 2015**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76628 / December 11, 2015**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 31934 / December 11, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-16999**

**In the Matter of**

**AARON NOWAK**

**Respondent.**

**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**

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Aaron Nowak ("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, and except as provided herein in Section V, 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, 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"), 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 Aaron Nowak's negligent participation in a fraudulent scheme perpetrated by certain employees at Linkbrokers Derivatives LLC ("Linkbrokers"), a New York based interdealer broker, to unlawfully take secret profits of more than $18 million at the expense of Linkbrokers' customers. Aaron Nowak and four other individuals (collectively "the Linkbrokers Team") worked on Linkbrokers' "Cash Desk," executing orders to purchase and sell securities on behalf of their customers, primarily large foreign institutions and foreign banks, and purportedly charging small commissions—typically between a fraction of a penny and two pennies per share.[2]

Typically, the Cash Desk executed trades for Linkbrokers' customers on a "riskless principal" basis. That is, the customer gave the Cash Desk the order, the order was filled in the market under Linkbrokers' name, then allocated to the customer. Thus, typically, Linkbrokers facilitated the transactions in exchange for the agreed-upon commission, and, essentially, served as an intermediary for others who assumed the market risk.

From at least 2005 through at least February 2009 (the "relevant period"), on over 36,000 customer transactions, the Linkbrokers Team perpetrated the scheme by charging customers false prices with embedded hidden markups or markdowns. In total, the sales brokers selectively engaged in the scheme when the volatility in the market was sufficient to conceal the fraud from the customer.

After receiving and executing orders on behalf of customers, the sales brokers routinely evaluated each transaction to determine whether they could make an additional or "secret" profit above the commission to be charged to the customer. The sales brokers considered other transactions in the relevant security occurring in the seconds to minutes before and after the actual trade was executed. Where the price fluctuated sufficiently to conceal the fraud from customers, a sales broker instructed Nowak or another sales trader to record, on Linkbrokers' internal records, a false execution price that included a secret profit. Then, Linkbrokers charged the customer the

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

[2] Gregory Reyftmann, Benjamin Chouchane and Marek Leszczynski were "sales brokers" and Aaron Nowak and Henry Condron were "sales traders" on the Linkbrokers Team.

inflated price while also charging the agreed-upon commission. In that way, Linkbrokers received not only the actual commission charged, but also the fraudulent secret profit that the sales broker, with assistance from Nowak on certain occasions, embedded in the price reported to the customer. In total, the Linkbrokers Team fraudulently over-charged customers by $18 million, representing approximately 40% of the Cash Desk's earnings during the relevant time period.

**Respondent**

1. Aaron Nowak, is a registered representative and has been associated with broker-dealers registered with the Commission from November 2004 until the present. Nowak was associated with Linkbrokers from November 2004 until April 2011 as a sales trader and middle-office assistant. In April 2011, he transferred to a new position at ICAP. He holds Series 7, 55 and 63 securities licenses. Nowak, 36 years old, is a resident of Greenwood Lake, New York.

**Other Relevant Entities and Individuals**

2. Linkbrokers was a Delaware limited liability company. During the relevant period, Linkbrokers' principal place of business was in New York, New York. It was registered with the Commission as a broker-dealer from 2003 until 2014. Linkbrokers ceased acting as a broker-dealer in April 2013 and withdrew its broker-dealer registration in November 2014. In the related administrative proceeding *In the Matter of Linkbrokers Derivatives LLC*, File No. 3-16017 (Aug. 14, 2014), Linkbrokers was ordered to pay disgorgement of $14 million.

3. Gregory Reyftmann ("Reyftmann"), age 41, was a sales broker and supervisor at Linkbrokers from February 2005 until June 2010. During that period, Reyftmann was the head of the Cash Desk and responsible for supervising Chouchane, Leszczynski, Condron, and others. He was a defendant in the related case *SEC v. Leszczynski*, et al., No. 12-cv-07488 (S.D.N.Y.), and on February 9, 2015, he was ordered to pay disgorgement, prejudgment interest and penalty totaling $8,720,140.

4. Benjamin Chouchane ("Chouchane"), age 41, was a sales broker at Linkbrokers from February 2005 until December 2010. He pled guilty in a criminal case arising from the same conduct discussed herein, *United States v. Leszczynski*, No. 12-cr-00923 (S.D.N.Y.). He was sentenced to twenty-four months imprisonment, two years supervised release, and ordered to pay $5 million in restitution. In addition, he was a defendant in the related case *SEC v. Leszczynski, et al.*, Civil Action No. 12-cv-07488 (S.D.N.Y.). He consented to a judgment entered on January 13, 2014, ordering him to pay disgorgement and prejudgment interest totaling $2,449,577. In the related administrative proceeding, *In the Matter of Benjamin Chouchane*, File No. 3-15739 (Feb. 4, 2014), Chouchane was barred, by consent, from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent and from participating in any penny stock offering.

5. Marek Leszczynski ("Leszczynski"), age 45, was a sales broker at Linkbrokers from March 2005 until December 2010. He pled guilty in a criminal case arising from the same

conduct discussed herein, *United States v. Leszczynski*, No. 12-cr-00923 (S.D.N.Y.). He was sentenced to eighteen months imprisonment, two years supervised release, and ordered to pay $1.5 million in restitution. In addition, he was a defendant in the related case *SEC v. Leszczynski, et al.*, Civil Action No. 12-cv-07488 (S.D.N.Y.). He consented to a judgment entered on January 13, 2014, ordering him to pay disgorgement of $1,500,000. In the related administrative proceeding, *In the Matter of Marek Leszczynski*, File No. 3-15738 (Feb. 4, 2014), Leszczynski was barred, by consent, from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent and from participating in any penny stock offering.

6. Henry A. Condron ("Condron"), age 36, was a sales trader and middle-office assistant at Linkbrokers from February 2005 until October 2010. He pled guilty in a criminal case arising from the same conduct discussed herein, *United States v. Condron*, No. 12-cr-768 (S.D.N.Y.). He was sentenced to eighteen months probation and ordered to pay $207,675 in restitution. In addition, he was a defendant in the related case *SEC v. Leszczynski, et al.*, Civil Action No. 12-cv-07488 (S.D.N.Y.). He consented to a judgment entered on January 13, 2014, ordering him to pay disgorgement and prejudgment interest totaling $207,675. In the related administrative proceeding, *In the Matter of Henry A. Condron*, File No. 3-15740 (Feb. 4, 2014), Condron was barred, by consent, from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent and from participating in any penny stock offering.

## Facts

7. During the relevant time period, Linkbrokers acted as an interdealer broker for institutional customers dealing in equities products, both cash and derivatives.

8. Linkbrokers established its Cash Desk in February 2005. The Cash Desk executed trades in U.S. and Canadian stocks. Its customers were primarily large foreign institutions and foreign banks. Typically, Linkbrokers operated as an agent and executed large volumes of securities trades on behalf of customers for low commissions. The Cash Desk typically did not hold any securities itself. The Cash Desk was one of several desks at Linkbrokers.

9. Linkbrokers marketed and advertised itself as an agency-only business. For example, in marketing materials distributed on March 8, 2007, Linkbrokers represented that "Link acts as a fiduciary in all transactions. Link trades on an agency basis in transactions with the sole purpose of providing best execution." In separate marketing materials distributed on January 4, 2007, Linkbrokers further stated that it provided "unparalleled execution without the conflicts of investment banking and proprietary trading."

10. Linkbrokers' internal records show that, for the majority of its customers, the Cash Desk was to charge its customers flat commission rates between $0.005 per share and $0.02 per share.

11. Reyftmann, Chouchane and Leszczynski were "sales brokers" on the Cash Desk and were responsible for finding customers, developing relationships, negotiating commission rates, taking orders from customers, and communicating with customers regarding their orders and Linkbrokers' execution of those orders. Reyftmann also supervised the Cash Desk during the relevant period.

12. Nowak and Condron were "sales traders" on the Cash Desk who entered orders they received from the sales brokers into systems for execution, and worked at the direction of Reyftmann.

13. Nowak and Condron also served as "middle-office assistants," who maintained and updated Linkbrokers' internal "trade blotter" (hereafter "Trade Blotter"), a spreadsheet generated from Linkbrokers' proprietary software program that contained detailed information about trades executed by the Linkbrokers Team, including the names of the customers and execution prices. The Trade Blotter contained three price fields: (1) the actual "execution price" received by Linkbrokers; (2) the "gross price" – the price that included the undisclosed markup/markdown; and (3) the "net price" – the gross price plus the agreed-upon commission rate. The Linkbrokers Team used the Trade Blotter to record profits from the unlawful scheme.

14. In addition, as middle-office assistants, Nowak and Condron reported customer trades to Linkbrokers' clearing firm (either through a transfer via Linkbrokers' proprietary software program or directly), reviewed trade settlements by the clearing firm, calculated daily profit and loss, and sent trade recaps and/or trade confirmations via email to customers.

15. Depending on the customer's preference, Linkbrokers, through Reyftmann, Chouchane and Leszczynski, accepted customer orders by telephone, instant message, or email. Nowak or other members of the Linkbrokers Team also confirmed trades to customers by telephone, instant message, email or mail, depending on the customer's preference.

**<u>The Undisclosed Markups/Markdowns</u>**

16. Members of the Linkbrokers Team concealed the markups/markdowns from Linkbrokers' customers by, among other things, misrepresenting execution prices to the customers, and omitting information relating to markups/markdowns.

17. The sales brokers opportunistically engaged in adding undisclosed markups/markdowns to trades when they thought the particular customer would not detect it, frequently taking advantage of market volatility to conceal the conduct.

18. The undisclosed markups/markdowns ranged anywhere from a few dollars to $228,822 per transaction.

19. The markup/markdown scheme worked in the following way:

a. A sales broker received a customer order either by telephone, instant message, or email.

b. The sales broker gave the order to a sales trader to execute.

c. The sales trader executed the trade.

d. After the order was executed, a middle-office assistant recorded the actual execution price on the Trade Blotter and informed the sales broker of the execution.

e. Shortly after the trade was executed, the sales broker examined other market executions in or around the time of the actual execution, to determine whether the stock price fluctuated. If the stock price's fluctuation was favorable to Linkbrokers and sufficient to conceal the fraud from Linkbrokers' customer, the sales broker instructed the middle-office assistant to record a false execution price in the gross price field on their internal Trade Blotter.

f. A member of the Linkbrokers Team reported the false execution price and the commission to the customer, and recorded the total charged to the customer in the net price field on their internal Trade Blotter.

20. Frequently, Nowak or other members of the Linkbrokers Team provided the false and/or misleading information through trade recaps communicated to customers by telephone, instant message, or email. The Linkbrokers Team also sent, or caused to be sent, trade confirmations containing the false and/or misleading information to some customers.

**Example Of A Markup/Markdown**

21. On September 29, 2008 at 3:54 p.m., a customer placed an order by telephone with Leszczynski to sell 90,000 shares of Citigroup, Inc. ("C"). Linkbrokers executed the trade at 3:56 p.m., selling 90,000 shares of C on the customer's behalf at an average price of $19.1311 per share. The Trade Blotter reflects an execution price of $19.1311, a gross price of $17.7500, and a net price of $17.7435. At 5:01 p.m., Nowak generated, and emailed to the customer, a trade confirmation containing the false execution price of $17.7500 per share. The commission for this transaction was $0.0065 per share, resulting in a total commission of $585 for the trade, which Linkbrokers charged and disclosed to the customer. However, Linkbrokers, and the Linkbrokers Team, failed to disclose that the actual execute price was $124,299 higher than the execution price reported to the customer, thereby taking this undisclosed profit for Linkbrokers at the expense of its customer.

**Nowak Was Negligent**

22. Nowak, through emailed trade recaps and trade confirmations sent to customers, caused the disclosure of false execution prices and inaccurate fees charged to customers.

23. Nowak was negligent in that he should have known that the confirmations sent to customers contained false and/or misleading information and omitted the markups/markdowns. Nowak received the false prices from the sales brokers and input them into Linkbrokers' internal database and then generated the confirmations or emailed the trade recaps that contained the false prices and omitted the markups/markdowns.

**Violation**

24. As a result of the negligent conduct described above, Nowak willfully[3] violated Sections 17(a)(2) and (3) of the Securities Act, which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities.

**IV.**

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

Accordingly, pursuant to Section 8A of the Securities Act, Section 15(b) of the Exchange Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondent Nowak cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) and (3) of the Securities Act.

B. Respondent Nowak be, and hereby is:

> barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent;
>
> 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; and

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[3] The use of the word "willful" does not reflect a finding that the actor intended to violate the law or knew that he was doing so. 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)).

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,

with the right to apply for reentry after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

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

D. Respondent shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of $5,000 to the Securities and Exchange Commission. 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 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 Aaron Nowak 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 G. Jeffrey Boujoukos, Associate Regional Director, Division of Enforcement, Securities and Exchange Commission, One Penn Center, 1617 JFK Boulevard, Suite 520, Philadelphia, PA 19103.

E. 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 D above. This Fair Fund shall be transferred to the related matter *In the Matter of Linkbrokers Derivatives LLC*, File No. 3-16017 (Aug. 14, 2014), and combined with the funds previously collected in that matter and distributed in accordance with the proposed distribution plan in that matter pursuant to Commission Rule 1101(a). 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, he shall not argue that he is entitled to, nor shall he 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 he shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

**V.**

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary

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**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 240**

**[Release No. 34-76624; File No. S7-26-15]**

**RIN 3235-AL72**

# Establishing the Form and Manner with which Security-Based Swap Data Repositories Must Make Security-Based Swap Data Available to the Commission

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission ("SEC" or "Commission") is publishing for comment a proposed amendment to specify the form and manner with which security-based swap data repositories ("SDRs") will be required to make security-based swap ("SBS") data available to the Commission under Exchange Act Rule 13n-4(b)(5). The Commission is proposing to require SDRs to make these data available according to schemas that will be published on the Commission's website and that will reference the international industry standards Financial products Markup Language ("FpML") and Financial Information eXchange Markup Language ("FIXML").

**DATES:** Comments should be received on or before **[insert date 60 days after publication in Federal Register]**.

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

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/proposed.shtml); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-26-25 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 to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-26-15. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/proposed.shtml). Comments are also available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

Studies, memoranda, or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the SEC's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by e-mail.

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**SUPPLEMENTARY INFORMATION:** The Commission is proposing to amend Rule 13n-4(a)(5) under the Exchange Act (defining "Direct electronic access" to data stored by an SDR).

## I. Introduction

On February 11, 2015, the Commission adopted Rules 13n-1 to 13n-11 under the Exchange Act (collectively, the "SDR Rules"),[1] which govern SDR registration, duties, and core principles.[2] On the same day, the Commission adopted Rules 900 to 909 under the Exchange Act (collectively, "Regulation SBSR"),[3] which govern the reporting to registered SDRs of SBS data and public dissemination by registered SDRs of a subset of that data.[4] In combination, these rules represent a significant step forward in providing a regulatory framework to promote transparency and efficiency in the OTC derivatives markets and assist relevant authorities in performing their market oversight functions.

Today, the Commission is proposing to amend the SDR Rules to specify the form and manner with which SDRs would be required to make SBS data available to the Commission. This rulemaking constitutes an important next step in the development of the SBS transaction

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1 17 CFR 240.13n-1 to 240.13n-11.

2 See Securities Exchange Act Release No. 74246 (February 11, 2015), 80 FR 14437 (March 19, 2015) ("SDR Adopting Release").

3 17 CFR 242.900 to 242.909.

4 See Securities Exchange Act Release No. 74244 (February 11, 2015), 80 FR 14563 (March 19, 2015) ("Regulation SBSR Adopting Release").

reporting regime mandated by the Dodd-Frank Act.[5] The proposed rule would require that SBS data made available by SDRs be formatted and structured consistently to allow the Commission to accurately analyze the data made available by a single SDR, and to aggregate and analyze data made available by multiple SDRs.

### A. Background

Rule 13n-4(b)(5) under the Exchange Act[6] requires an SDR to provide direct electronic access to the Commission (or any designee of the Commission, including another registered entity). Under Rule 13n-4(a)(5),[7] "direct electronic access" means "access, which shall be <u>in a form and manner acceptable to the Commission</u>, to data stored by a security-based swap data repository in an electronic format and updated at the same time as the security-based swap data repository's data is updated so as to provide the Commission or any of its designees with the ability to query or analyze the data in the same manner that the security-based swap data repository can query or analyze the data" (emphasis added). As discussed in detail below, the

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5 Pub. L. No. 111-203, 124 Stat. 1376 (2010). The Dodd-Frank Act was enacted, among other reasons, to promote the financial stability of the United States by improving accountability and transparency in the financial system. <u>See</u> Pub. L. No. 111-203, Preamble. The 2008 financial crisis highlighted significant issues in the over-the-counter ("OTC") derivatives markets, which experienced dramatic growth in the years leading up to the financial crisis and are capable of affecting significant sectors of the U.S. economy. Title VII of the Dodd-Frank Act provides for a comprehensive new regulatory framework for swaps and security-based swaps, by, among other things: (1) providing for the registration and comprehensive regulation of swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants; (2) imposing clearing and trade execution requirements on swaps and security-based swaps, subject to certain exceptions; (3) creating recordkeeping, regulatory reporting, and public dissemination requirements for swaps and security-based swaps; and (4) enhancing the rulemaking and enforcement authorities of the Commission and the Commodity Futures Trading Commission ("CFTC").

6 17 CFR 240.13n-4(b)(5).

7 17 CFR 240.13n-4(a)(5).

Commission is proposing to set out the form and manner for direct electronic access to SDRs that is acceptable to the Commission.

As the Commission noted in the SDR Adopting Release, a significant portion of the benefits of an SDR will not be realized if the Commission obtains direct electronic access to the data stored at an SDR in a form or manner that cannot be easily utilized by the Commission.[8] Furthermore, the form and manner with which an SDR provides the data to the Commission should not only permit the Commission to accurately analyze the data maintained by a single SDR, but also allow the Commission to aggregate and analyze data received from multiple SDRs.[9] The form and manner that will be acceptable to the Commission for an SDR to provide direct electronic access may vary on a case-by-case basis and may change over time, depending on a number of factors.[10] These factors could include the development of new types of security-based swaps or variations of existing security-based swaps that require additional data to accurately describe them.[11] Additionally, the extent to which the Commission encounters difficulty in standardizing and aggregating SBS data across multiple SDRs would be a factor in considering the nature of the direct access provided by an SDR to the Commission.[12]

In the SDR Adopting Release, the Commission also stated that, until such time as the Commission adopts specific formats and taxonomies, SDRs "may provide direct electronic access to the Commission to data in the form in which the SDRs maintain such data."[13] Under

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8 See 80 FR at 14474.

9 See id.

10 See id.

11 See id.

12 See id.

13 See id. at 14475.

this guidance, an SDR could provide direct electronic access to data in a form and manner that is not conducive to the Commission's ability to analyze the data or surveil the SBS market. For example, a particular SDR might provide direct electronic access to data in the same format in which the data were received from its participants. If participants report data to the SDR using different conventions, inconsistencies in data formats within the SDR might limit or impair the Commission's ability to accurately aggregate positions within the SDR or to compare the features of one market participant's transactions or positions to those of another market participant.

### B. Overview of Proposed Amendment

The Commission proposes to amend Rule 13n-4(a) to specify the form and manner with which SDRs must provide direct electronic access to the Commission by requiring SDRs to comply with an appropriate schema as will be published on the Commission's website.

In the SDR Adopting Release, the Commission stated that it believed it was in the best position to aggregate data across multiple SDRs.[14] The Commission also stated that if it were to propose a particular format for the direct electronic access, it would propose detailed specifications of acceptable formats and taxonomies that would facilitate an accurate interpretation, aggregation, and analysis of SBS data by the Commission.[15] Any proposed format also would maximize the use of any applicable current industry standards for the description of SBS data.[16]

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14 Id.

15 Id. at 14474-75.

16 Id. at 14475.

The Commission is currently aware of only two industry standards for representing SBS data: FpML [17] and FIXML.[18] The Commission is proposing to accommodate both industry standards by specifying that either of two distinct schemas[19] would satisfy the requirements of Rule 13n-4. One schema would rely on the FpML standard and the other schema would rely on the FIXML standard. Both schemas would articulate the same common data model, which is the logical representation of the data elements required to be reported under Regulation SBSR. The Commission preliminary believes that each schema would facilitate the consistent reporting of SBS transaction characteristics, such as the counterparties, associated other parties (e.g., brokers), and corresponding terms of payments. In addition, validations associated with the schemas would help SDRs ensure that the data they make available to the Commission adhere to the common data model.

As discussed below in more detail, the Commission preliminarily believes that both industry standards already cover many of the data elements that must be reported to registered SDRs under Regulation SBSR. In the appendix, the Commission has highlighted clear cases where the schemas require additional elements that do not yet exist in FpML or FIXML to represent all data elements that must be reported under Regulation SBSR and that registered SDRs must accept and store.

This release solicits comment on the Commission's proposal concerning the form and manner with which SDRs provide the Commission with direct electronic access, including whether the Commission should accept both the FpML and FIXML standards, whether the

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17 FpML is a registered trademark of the International Swaps and Derivatives Association, Inc.

18 FIXML is a registered trademark of Fix Protocol Limited.

19 The term "schema" is generally applied to formal representations of data models.

Commission should accept only one or the other, whether the Commission should accept other protocols or standards, and whether the Commission's incorporation of validations into the schemas supports completeness of the SBS data.

## II. Discussion of the Proposed Amendment

### A. Discussion of Existing Industry Standards

Industry standards have evolved to enable participants in the SBS market to capture and communicate certain trade information. As discussed in more detail below, these standards have evolved for use in different contexts but inherently share features that are relevant for SBS data standardization and aggregation.

#### 1. Background of Existing Industry Standards

The Commission is aware of two existing industry standards which are used by market participants to capture trade-related information: FpML and FIXML . FpML and FIXML are both international open industry standards, meaning that they are technological standards that are widely available to the public, royalty-free, and at no cost. In addition, they are both independent of the software and hardware used by participants, thus facilitating interoperability. Both FpML and FIXML have evolved for use in different contexts and they share features that are relevant for rendering SBS data compatible for the purposes of normalization, aggregation, and comparison.

FpML was developed under the auspices of the International Swaps and Derivatives Association (ISDA),[20] using the ISDA derivatives documentation as its basis. FpML maintenance and continued development is undertaken by the FpML Standards Committee,

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20 ISDA is a global organization of derivatives market participants. ISDA has developed standardized Master Agreements underlying derivatives transactions and manages the development of FpML. See http://www2.isda.org/ (last visited Dec. 8, 2015).

which operates under the auspices of ISDA and is made up of representatives from a range of financial market participants, including banks, brokers, central counterparties (CCPs), and other financial infrastructure providers. FpML was designed for the OTC derivatives industry to capture data elements that provide a complete and accurate representation of the contractual provisions of a trade in derivatives or structured products. FpML is used by market participants to communicate OTC transaction details to counterparties and post-trade processors, and is designed to facilitate validation of message contents. FpML is also designed to be useful within firms for the purposes of sharing OTC transaction information across systems.[21] The FpML Standards committee maintains FpML and updates it from time to time.[22]

In contrast to FpML's focus on post-trade communication of standardized derivatives contracts, Financial Information eXchange (FIX) is a messaging protocol developed for pre-trade communication and trade execution of standardized and bespoke contracts for multiple asset classes and markets. The FIX protocol enables electronic communication between broker-dealers and their institutional clients to deliver quotes, submit orders, and execute trades. Since its inception in 1992 as a standard used to trade equities, the use of FIX was further developed to include fixed income, derivatives, and foreign exchange, and the scope of FIX has been extended to include pre-trade, trade, and post-trade business processes[23] using FIXML, an eXtensible Markup Language (XML) based implementation of the FIX messaging standard. FIXML

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21 See FpML® Information, https://dedicated.fpml.org/about/factsheet.html (last visited Dec. 8, 2015).

22 See infra note 82.

23 Oxera Consulting Ltd., What are the benefits of the FIX Protocol? Standardising messaging protocols in the capital markets, at 5 (2009), available at http://www.oxera.com/Oxera/media/Oxera/Benefits-of-the-FIX-Protocol.pdf?ext=.pdf.

embeds FIX messages in an XML document that includes structures that are specific to the FIX protocol. The FIX messaging standard is owned, maintained, and developed through the collaborative efforts of the FIX Trading Community.[24]

Both FpML and FIXML were derived from the XML standard. Each standard uses an XML-based schema to impose structure on the order and content of, and relationships among, data elements, including the particular data types that correspond to each data element. FpML and FIXML mark up or "structure" data using standard but distinct definitions. These data element definitions establish a consistent structure of identity and context so that the reported data can be recognized and processed by standard computer code or software (i.e., made machine readable). For example, under Regulation SBSR, the title and date of agreements incorporated by reference in a SBS contract must be reported to a registered SDR for certain transactions.[25] To convey this information electronically, the data must be structured with the role of the agreement (such as master, collateral, or margin), the title of the agreement, and the date of the agreement.

The Commission notes that the bodies responsible for the maintenance of both FpML and FIXML have experience engaging with the regulatory community and have made enhancements specifically to support regulatory requirements. FpML currently supports several regulatory reporting requirements other than those imposed by the Commission as part of Regulation

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24 FIX Trading Community is a non-profit, industry-driven standards body comprised of over 270 member firms from the global financial services industry. See Letter from FIX Trading Community to Commodity Futures Trading Commission (May 27, 2014), available at http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59866&SearchText=.

25 17 CFR 242.901(d)(4).

SBSR,[26] and has a working group currently considering SBS data reporting requirements.[27] The FIX Trading Community has enhanced FIXML to support the trade capture requirements of the CFTC.[28] FIXML is used for asset- and mortgage-backed securities trade reporting to FINRA.[29] The Australian Securities and Investments Commission published FIXML requirements for the disclosure and reporting of short sales.[30] The Investment Industry Regulatory Organization of Canada adopted FIXML for market surveillance and transactional reporting.[31]

The Commission preliminarily believes that both standards have been implemented by market participants and are widespread in use, and that the taxonomies for both standards for SBS reporting have developed sufficient coverage such that the Commission does not need to develop its own standard for the required data elements.[32] If the Commission were to adopt a rule that required SDRs to make SBS data available to the Commission using the FpML or FIXML standards, the Commission anticipates that its staff would keep apprised of relevant advances and developments with those standards and engage with each standard's working group regarding such developments, as appropriate.

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26 See FpML Global Regulatory Reporting Mapping 2014 v9 (Feb 27) (Working Draft), available at http://www.fpml.org/asset/40388bcb/6a20cde6.xlsx.

27 See Reporting/Regulatory Reporting Working Group Charter, http://www.fpml.org/wgroup/rptwg/rptwgcharter.doc.

28 See Letter from FIX Protocol Limited to SEC (August 5, 2010), available at http://www.sec.gov/comments/s7-11-10/s71110-32.pdf.

29 Id.

30 Id.

31 Id.

32 See Appendix.

2. Interoperability and Acceptance of Existing Standards

Interoperability is the ability of two or more systems to exchange data and for the data to be automatically interpreted. While FpML and FIXML both rely on XML to exchange data, they are not interoperable unless a common data model is built that allows a translation between the two standards. As a result, the Commission has developed a common data model that uses as a basis the existing overlap of the standards' current coverages of SBS data. The Commission's common data model is a representation of the SBS data elements required to be made available to the Commission. The Commission preliminarily believes that requiring SDRs to use either the FpML or FIXML schema will help achieve one of the key objectives of Regulation SBSR, which is to have a complete and intelligible record of all SBS transactions for oversight purposes. The common data model is represented by two separate schemas, one each for the FIXML and FPML standards. Accordingly, under the proposed amendment, SDRs can make SBS data available to the Commission using either the FIXML or FpML schema. The Commission describes both the common data model and the two schemas in greater detail below.

The Commission notes that ISDA and the FIX Community formed the FpML Collaboration Working Group in 2004 to support certain aspects of interoperability between FpML and FIXML.[33] For example, the group addressed the question of how swap execution facilities would handle the transformation of a FIX message into an FpML message for use in post-trade confirmation, clearing, and trade reporting with a solution that supports detailed FpML messages contained within a compact FIX message. The group also facilitated a common approach to data items for capture of interest rate and credit default swaps during the pre-trade

[33] See 2012 FIX-FpML Collaboration WG Charter, http://www.fixtradingcommunity.org/mod/file/download.php?file_guid=46484.

and trade lifecycles. To date, the Commission's understanding is that this group has not generated a common data model as proposed in this release.

### 3. Proposed Amendment to Rule 13n–4(a)(5) to Specify the Format for Direct Electronic Access

The Commission is proposing to amend Rule 13n–4(a)(5) to specify the form and manner with which SDRs must provide direct electronic access to the Commission. In particular, under the proposal, SDRs must provide direct electronic access using either the FpML schema or the FIXML schema as published on the Commission's website. The Commission is also proposing to require that the SDRs use the most recent schema as published on the website as the Commission anticipates that the schemas will be updated periodically to reflect changes in the FpML and FIXML standards, or to reflect changes in industry practice or financial products covered by Regulation SBSR. As with the Commission's updates to other taxonomies and schemas,[34] Commission staff will post draft schemas on the Commission's website for the public to review and provide comment before posting any final schemas.

## B. Commission Schemas

As mentioned above, the Commission has developed a common data model, which is the logical arrangement of the data elements that comprise a transaction report as described under Regulation SBSR and how those data elements relate to each other. The purpose of the common data model is to improve the consistency and reliability of the data made available to the Commission for analysis and aggregation along various dimensions, such as across SDRs, within an SDR, by counterparty, or by product. The Commission's common data model reflects the

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34 See, e.g., Rating History Files Publication Guide, http://xbrl.sec.gov/doc/rocr-publication-guide-draft-2014-12-15.pdf, and Release Notes for SEC Taxonomies 2015-Draft, http://xbrl.sec.gov/doc/releasenotes-2015-draft.pdf.

reporting requirements under Regulation SBSR. The Commission's schemas for SBS data are formal representations of the Commission's common data model.

For example, a schema representing the common data model would require that a transaction record made available to the Commission include the terms of any standardized fixed or floating rate payments that correspond exactly to Rule 901(c)(1)(iv). However, consistent with Regulation SBSR, such a schema would allow flexibility in how information may be reported to a registered SDR. For example, consistent with Rule 901(c)(1), a schema that represents the common data model would not require data elements to satisfy Rules 901(c)(1)(iv) if a product ID reported under Rule 901(c)(1) already includes the information that would be captured by data elements associated with Rules 901(c)(1)(iv) data elements.

To implement the common data model into an electronic format according to which SDRs could provide direct electronic access to the Commission, the Commission has developed two distinct schemas (computer code representations of the common data model), one based on the FpML standard, and the other based on the FIXML standard. Under the proposed amendment, an SDR could provide the Commission with direct electronic access by using either schema or both schemas. SBS transaction records structured according to one of the schemas could be immediately aggregated, compared, and analyzed by the Commission.

At this time, the Commission is aware of only the FpML and FIXML standards for representing SBS data. In its evaluation of the potential applicability of these two standards for the purpose of regulatory reporting of SBS transactions, Commission staff undertook a mapping exercise, the results of which are reported in the appendix, to determine how much of the Commission's common data model could be represented using the existing reporting elements within the two standards. Commission staff found that there exists significant overlap between the FpML and FIXML standards in their descriptions of SBS data, and that almost all concepts of the common data model can be represented with existing FpML and FIXML reporting elements.[35] In light of this and the SBS industry's current familiarity with and acceptance of these widely-used standards, the Commission believes that using FpML and FIXML schemas is an efficient and effective approach for satisfying the necessary form and manner of direct electronic access. Moreover, in light of prior engagement with the regulatory community and prior efforts to support regulatory requirements by the bodies that maintain both FpML and FIXML,[36] the Commission anticipates that the bodies responsible for maintaining each industry standard are likely to update these standards to incorporate any remaining data elements needed for the purpose of reporting under SBSR. In particular, Commission staff has identified concepts within the proposed common data model that do not currently have equivalent data elements in FpML or FIXML. As discussed further below, in cases where concepts within the common data model do not yet have equivalents in FpML or FIXML, the Commission's schemas use extensions of existing FpML and FIXML reporting elements that accommodate the kind of data required by the common data model's concept.

Both FpML and FIXML employ data models to logically arrange and organize their respective data elements in specific ways. These data models reflect each's' decisions regarding how to represent their data elements for reporting and communication purposes. The Commission's schemas would not require alteration of the standards' data models, but rather would incorporate each standard's data models as they are used to represent one of their data elements. As a result, the mapping of FpML and FIXML to the common data model does not

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35 See Appendix.

36 See Section II.A.1.

necessarily reflect a one-to-one mapping between named data elements. In some instances, a single concept in the Commission's common data model maps to a group of data elements within FpML or FIXML. For example, FIXML models the terms of any standardized fixed rate payments by arranging multiple FIXML data elements that each represent a different attribute of a payment stream, including settlement currency, day count convention, and fixed rate. This FIXML data model composed of multiple data elements maps to a single concept in the common data model that corresponds to Rule 901(c)(1)(iv).[37]

### 1. Common Data Model Treatment of Broad Categories of Transaction Information

Below, we describe how Regulation SBSR provides the basis for the requirements of the common data model by examining how the schemas representing the common data model would treat broad categories of transaction information and how they would define relationships between specific data elements within those broad categories by placing restrictions on SBS data. The Commission notes that the concepts within the common data model are limited to those required to be reported to registered SDRs under Rules 901, 905, and 906 and required to be assigned by registered SDRs under Rule 907. The common data model also relies on definitions provided by Rule 900.

#### a. Primary Trade Information

Rule 901(c) sets forth the data elements of a security-based swap that must be reported to a registered SDR and will then be publicly disseminated by the registered SDR pursuant to Rule 902(a) (unless an exception applies). These data elements generally encompass the means of identifying the contract and the basic economic terms of the contract and include any

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37 See Appendix.

standardized payment streams associated with a contract, the notional value of the contract, the transaction price, and other information necessary for interpreting transaction prices such as a variable that would indicate the intent to clear a transaction.

In order for the Commission to aggregate and analyze SBS data, Regulation SBSR requires reporting participants to report certain information about each security-based swap transaction. To provide a standardized means for identifying security-based swaps that share certain material economic terms, the Commission requires reporting participants to utilize a product ID of a security-based swap when one is available.[38] If the security-based swap has no product ID, or if the product ID does not include the information enumerated in Rules 901(c)(1)(i)-(v) of Regulation SBSR, then the information specified in subparagraphs (i)-(v) of Rule 901(c)(1) must be reported separately.[39] The FpML and FIXML schemas would allow these data elements described in Rules 901(c)(1)(i)-(v) to supplement product IDs, and validations in each schema would indicate an error if the product ID is not provided and none of these supplementary data elements are included. In addition, as contemplated by Rule 901(c)(1)(v), the common data model would include a "custom swap flag" that would indicate when the information provided pursuant to Rules 901(c)(1)(i)-(iv) does not provide all of the material information necessary to calculate the price of a security-based swap.

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38 See Regulation SBSR Adopting Release, 80 FR at 14570.

39 Subparagraph (i) requires information that identifies the security-based swap, including the asset class of the security-based swap and the specific underlying reference asset(s), reference issuer(s), or reference index. Subparagraph (ii) requires the effective date. Subparagraph (iii) requires the scheduled termination date. Subparagraph (iv) requires the terms of any standardized fixed or floating rate payments, and the frequency of any such payments. Subparagraph (v) requires a bespoke condition flag if the security-based swap is customized to the extent that the information provided in subparagraphs (i)-(iv) of Rule 901(c)(1) does not provide all of the material information necessary to identify the customized security-based swap or does not contain the data elements necessary to calculate the price.

Rule 901(c) also requires reporting of certain details about an SBS transaction, including the execution time, price, and notional amount. The precise formats in which these elements can be provided have been determined by each industry standard. For example, the various FIXML data elements that express execution time are all expressed in coordinated universal time (UTC). Similarly, currencies that denominate price and notional amount are expressed using ISO 4217 currency codes.[40]

Finally, the common data model would include concepts that correspond to requirements in Rules 901(c)(5) and 901(c)(6) for flags that indicate inter-dealer transactions and transactions that counterparties intend to clear. In addition to these required flags, Rule 901(c)(7) requires that the person with a duty to report include any additional transaction flags as specified in the policies and procedures of the registered SDR to which they report.

b. Reportable Events and Transaction Identifiers

Rule 901(a) assigns reporting duties for the security-based swaps described in Rule 908(a), including new security-based swaps and those that result from the allocation, termination, novation, or assignment of other security-based swaps. Rule 901(e) requires reporting of life cycle events. Rule 901(i) requires reporting, to the extent the information is available, of security-based swaps entered into before the date of enactment of the Dodd-Frank Act and security-based swaps entered into after the date of enactment but before Rule 901 becomes fully operative. Finally, Rule 905 sets out procedures for correcting errors to previously submitted transaction information. The schemas would include requirements for all of these event types. Both FIXML and FpML currently support the reporting of both new

40 See ISO 4217 – Currency Codes, http://www.iso.org/iso/home/standards/currency_codes.htm (last visited Dec. 8, 2015).

transactions as well as most of the other types of events required to be reported under Regulation SBSR, and so the schemas would include explicit mappings between existing FIXML and FpML events and those included in the common data model as a result of reporting requirements under Regulation SBSR.

Under Rule 901(g), a registered SDR must assign a transaction ID to each new security-based swap that is reported to it or establish a methodology for doing so. Further, Rule 901(d)(10) requires reports of allocations, termination, novation, or assignment of one or more existing security-based swaps to include the transaction ID of the security-based swap that is allocated, terminated, novated, or assigned, while Rule 901(e)(2) requires reports of life cycle events to include the transaction ID of the original transaction. As the Commission discussed in the Regulation SBSR Adopting Release, requiring the use of a transaction ID in these instances would enable the Commission to update a transaction record to incorporate the life cycle event and map a new security-based swap to a corresponding prior transaction, even if the prior transaction was reported to a different registered SDR.[41] To ensure consistency in the use of transaction IDs and enable the Commission to link together related transactions even if stored at different SDRs, the schemas that represent the common data model would stipulate how transaction reporting would link new trade activity and life cycle events to existing transactions through the use of the transaction ID. Further, the schemas would stipulate how an SDR would include the original transaction ID on records that involve allocations, terminations, novations, or assignments.

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41 See Regulation SBSR Adopting Release, 80 FR at 14589.

c. Market Participant Identifiers

Rules 901(d)(1), 901(d)(2), 901(d)(9), 906(a), and 906(b) require reporting of the identity of each counterparty to a security-based swap as well as certain other persons who are affiliated with the counterparties or are otherwise involved in the transaction but who are not counterparties of that specific transaction. Because the Commission has recognized the Global Legal Entity Identifier System (GLEIS) as an Internationally Recognized Standard Setting System (IRSS) that assigns unique identification codes ("UICs") to persons, these types of persons are required to obtain an LEI and registered SDRs are required to use these LEIs to identify these persons. Because the requirement to obtain an LEI does not apply to all persons enumerated in Rules 901(d)(1), 901(d)(2), 901(d)(9), 906(a), and 906(b), the schemas would accommodate identifiers that are not LEIs.[42]

Similarly, the schemas would accommodate LEI and non-LEI identifiers for execution agent IDs and broker IDs, since such persons might not have an LEI. Further, because no IRSS meeting the requirements of 903(a) has assigned or developed a methodology for assigning branch IDs, trader IDs, and trading desk IDs, the schemas would accommodate the identifiers or methodologies developed by the registered SDRs.

d. Cash Flows for Customized Contracts

Rule 901(d)(3) requires reporting of details regarding the payment terms, frequencies, and contingencies for non-standard, or bespoke, contracts. The schemas would accommodate these as separate data elements by including restrictions so that these data elements would be permitted only if the custom swap flag discussed in Section II.B.1.a is set by the registered SDR based on the transaction data that it receives from the reporting participant.

[42] See id. at 14632.

e. Agreements

Rule 901(d)(4) requires, for transactions that are not clearing transactions, the title and date of any master agreement, collateral agreement, margin agreement, or any other agreement incorporated by reference into the SBS contract. For example, to reflect these reporting requirements the schemas would include a flag to identify clearing transactions. For purposes of validation, if the clearing transaction flag is not set by the registered SDR, the registered SDR would be required to provide the agreement information provided by a reporting side under Rule 901(d)(4), if applicable, as separate data elements as well as provide the settlement details provided by reporting participants under Rule 901(d)(8). If instead the clearing transaction flag identifies a security-based swap as a clearing transaction, the associated transaction record would be valid even in the absence of the title and date of any master agreement, collateral agreement, margin agreement, or any other agreement incorporated by reference into the SBS contract because the Commission believes it could obtain this information from the registered clearing agency as necessary.[43] Additionally, if the clearing transaction flag is not set because of the exception in Section 3C(g) of the Exchange Act (15 U.S.C. 78c–3(g)) has been invoked, then an indication would be provided by the SDR.

f. Clearing

Under Rule 901(c)(6), the person with the duty to report must indicate with a flag whether there is an intent to clear a transaction. The schemas would include such a flag. Rule 901(d)(6) also requires reporting of the name of the clearing agency to which the swap will be submitted for clearing. Therefore, if the reporting participant[44] has included an "intent to clear"

43 See Regulation SBSR Adopting Release, 80 FR at 14586.

44 See §242.901(a).

flag, then expression of the intent to clear within the common data model would require the registered SDR to also include the name of the clearing agency to which the security-based swap will be submitted for clearing.

2. Required Reporting Elements that Do Not Exist in FpML or FIXML

As mentioned earlier, some concepts within the common data model do not currently have existing equivalents within FpML or FIXML. These include:

- custom swap flag;[45]
- the currencies of any upfront payment,[46] if applicable;
- a description of the settlement terms;[47]
- inter-dealer swap flag;[48]
- the title of any margin agreement;[49] and
- the date of any margin agreement.[50]

In these cases, the schemas would require specific extensions of existing FpML and FIXML reporting elements. For flags required by Rule 901(c)(7), the Commission's schemas would require registered SDRs to populate the section with the flags identified within their own policies and then to select from those. As we discuss in Section III.C.2, both FpML and FIXML undergo regular updates. To the extent that the FpML and FIXML standards address the common data model as part of their periodic updates, the Commission expects that the standards will create defined elements to replace the initial use of extensions. When the Commission

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45 See §242.901(c)(1)(v).

46 See §242.901(c)(3).

47 See §242.901(d)(8).

48 See §242.901(c)(5).

49 See §242.901(d)(4).

50 See id.

periodically updates its schemas, each schema will reflect the most recent version of each standard.

3. Validations

As mentioned above, the schemas would incorporate validations. These validations are restrictions placed on the form and manner of the reported SBS data that help ensure that the data SDRs make available to the Commission adhere to the appropriate schema. In particular, the validations test for completeness of the data and for appropriate format. As a result, the validations will enhance the Commission's ability to normalize and aggregate the data. These validations are effective at testing for whether the SBS data conforms to the technical specifications of the schema. However, these validations will not test for whether the SBS data accurately reflects the transaction that took place. By using the incorporated validations, SDRs will help ensure that their stored data adheres to the appropriate schema, thereby providing the Commission with direct electronic access pursuant to Rule 13n-4(b)(5).

4. Regulatory and Technical Coordination

In developing these proposed rules, we have consulted and coordinated with the CFTC and the prudential regulators[51] in accordance with the consultation mandate of the Dodd-Frank Act.[52] We have also incorporated the past experiences of the CFTC regarding their swap data

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51 The term "prudential regulator" is defined in section 1a(39) of the Commodity Exchange Act, 7 U.S.C. 1a(39), and that definition is incorporated by reference in section 3(a)(74) of the Exchange Act, 15 U.S.C. 78c(a)(74). Pursuant to the definition, the Board of Governors of the Federal Reserve System ("Federal Reserve Board"), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, or the Federal Housing Finance Agency (collectively, the "prudential regulators") is the "prudential regulator" of a security-based swap dealer or major security-based swap participant if the entity is directly supervised by that regulator.

52 Section 712(a)(2) of the Dodd-Frank Act provides in part that the Commission shall "consult and coordinate to the extent possible with the Commodity Futures Trading

collection efforts, and consulted with both the CFTC and U.S. Department of the Treasury's Office of Financial Research regarding draft technical documentation, including the FIXML and FpML schemas. More generally, as part of the Commission's coordination efforts, Commission staff continue to participate in bilateral and multilateral discussions, task forces, and working groups on data harmonization and the regulation of OTC derivatives.

### C. Request for Comment

- The Commission has developed two interoperable schemas so that SDRs can make SBS transaction data available to the Commission using already existing standards in a form and manner that can be easily utilized by the Commission for analysis and aggregation. Are there other ways to provide for the representation of SBS transactions that could be easily utilized by the Commission? If so, what are they? What are their strengths and weaknesses?

- Should the Commission require direct electronic access be provided by SDRs using only an FpML schema? Should the Commission require direct electronic access be provided by SDRs using only an FIXML schema? Is there another standard that the Commission should consider as acceptable? If so, which characteristics about that standard should make it acceptable to the Commission and how does that standard affect the Commission's ability to normalize, aggregate, and analyze the SBS data?

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Commission and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible."

- Does the Commission's approach to providing for direct electronic access using either the FpML or FIXML schemas allow for the accurate representation of SBS transactions as described in Regulation SBSR? If not, why not?

- Are the FpML and FIXML standards sufficiently developed to require either one of them to be used by SDRs to provide access to the required SBS data? What factors or indicators should the Commission use to determine when an SBS-related standard has become sufficiently developed to require its use for providing the Commission with direct electronic access to SBS data?

- Should the Commission allow SDRs to develop their own standards or leverage other standards to provide access to the Commission? How would the Commission's ability to normalize, aggregate, and analyze the data be affected if SDRs used different standards and developed different schemas for representing the SBS data?

- Instead of leveraging industry standards, such as FIXML and FpML, should the Commission create a new standard or contract with a third-party to create a new standard? Why or why not?

- Are there other approaches to developing or using a standard that the Commission should consider? Please explain in detail.

- What would be the costs to an SDR to provide data in either FpML or FIXML standard? Are there other ways that SBS data should be provided to the Commission? Are there other standards that would cost less but still allow the Commission to similarly normalize, aggregate, and analyze the data?

- Should the Commission institute a test phase for providing this information in either an FpML or FIXML standard? If so, how long should this test phase last?

- Other than using schemas, is there another effective mechanism for SDRs to provide direct electronic access to the Commission that still achieves similar or better aggregation and consistency results?

- The Commission intends to incorporate validations into its schemas to help ensure the quality and completeness of the SBS data that SDRs make available to the Commission. Is there another effective mechanism that would help ensure completeness and still achieve similar or better aggregation and consistency results?

- How should the common data model support reporting requirements that do not yet have equivalents in FpML or FIXML, while preserving the ability to normalize, aggregate, and analyze the data? As discussed in Section II.B.2, the Commission's schemas would require specific extensions of existing FpML and FIXML reporting elements. Is there a better alternative? Specifically, how would the alternative affect SDRs, the Commission, and market participants?

## III. Economic Analysis

On February 11, 2015, the Commission adopted the SDR Rules,[53] which govern SDR registration, duties, and core principles,[54] and Regulation SBSR, which governs the reporting to registered SDRs of SBS data and public dissemination by registered SDRs of a subset of that data.[55] In combination, these rules represent a significant step forward in providing a regulatory

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53 See supra note 1.

54 See supra note 2.

55 See supra notes 3-4.

framework to promote transparency and efficiency in the OTC derivatives markets and assist relevant authorities in performing their market oversight functions. As noted earlier in Section I.A, the Commission is concerned that SDRs might provide direct electronic access to data in a form and manner that is not conducive to the Commission's ability to analyze the data or surveil the SBS market. Under the proposed amendment, the Commission would specify the form and manner with which SDRs must provide direct electronic access to the Commission by requiring SDRs to comply with the appropriate schema as will be published on the Commission's website.

The Commission is sensitive to the economic effects of the rules that it proposes, including implications for efficiency, competition, and capital formation. The Commission preliminarily believes that the proposed rule would provide a number of benefits and result in certain costs. Section 23(a)(2) of the Exchange Act[56] requires the Commission, when making rules under the Exchange Act, to consider the impact that any new rule would have on competition. In addition, Section 23(a)(2) prohibits the Commission from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Furthermore, Section 3(f) of the Exchange Act[57] requires the Commission, when engaging in rulemaking pursuant to the Exchange Act 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.

In many instances the potential benefits and costs of the proposed amendment are difficult to quantify. In particular, the Commission does not have precise estimates of the

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56 15 U.S.C. 78w(a)(2).

57 15 U.S.C. 78c(f).

monetary benefits arising from the anticipated improvement in the Commission's ability to accurately analyze data made available by a single SDR, and the anticipated improvement in the Commission's ability to aggregate and analyze data made available by multiple SDRs. Benefits may arise from these improvements indirectly to the extent that facilitating the Commission's oversight of SBS market activity reduces the likelihood of abuse in the SBS market and risks to financial stability emanating from the SBS market, however the Commission does not have data that would enable it to estimate the magnitude of either of these effects.

Similarly, the Commission also does not have the data to estimate the potential costs that might be associated with reduced competition in the SDR industry that could result from the proposed approach. As we discuss in more detail below, a potential result of reduced competition among SDRs is that SDRs increase prices for their services or decrease the quantity or quality of their services. While the Commission acknowledges these potential costs, it does not have information about SDR services that would be necessary to estimate changes in prices, quality of service, or quantity of service that might result from reduced competition. One reason for this lack of information is that, to date, no SDRs have registered with the Commission. Where possible, we provide quantitative estimates of the potential costs of the proposed amendments. We provide discussions of a qualitative nature when quantification is not possible.

### A. Economic Baseline

To examine the potential economic effects of the proposed amendments, our analysis considers as a baseline the rules adopted by the Commission that affect regulatory reporting and public dissemination, particularly those rules adopted as part of Regulation SBSR and the SDR Rules. The baseline includes our current understanding of international industry standards and market practices, including how those standards and practices have been influenced by the actions of other regulators. This section begins by summarizing the economic implications of regulatory reporting and public dissemination under the Commission's current regulatory framework for the SBS market and describing the data currently made available to the Commission on a voluntary basis. Following this discussion, the section describes the number of SDRs likely to be affected by the proposed amendments before examining the current state of the FIXML and FpML standards.

1. The SDR Rules and Regulation SBSR

As mentioned above, the Commission recently adopted the SDR Rules and Regulation SBSR. Together, the rules seek to provide improved transparency to regulators and the markets through comprehensive regulations for SBS transaction data and SDRs.[58] As the Commission envisioned in the SDR Adopting Release, SDRs will become an essential part of the infrastructure of the SBS market.[59] Persons that meet the definition of an SDR will be required by the SDR Rules to maintain policies and procedures relating to data accuracy and maintenance, and will be further required by Regulation SBSR to publicly disseminate transaction-level data, thereby promoting post-trade transparency in the SBS market.

Additionally, as a result of the SDR Rules and Regulation SBSR, increased quality and quantity of pricing and volume information and other information available to the Commission about the SBS market may enhance the Commission's ability to respond to market developments. To help inform its understanding of the SBS market, the Commission currently relies upon data on individual CDS transactions voluntarily provided by the Depository Trust and Clearing Corporation ("DTCC") Trade Information Warehouse ("TIW"). This information

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58 See SDR Adopting Release, 80 FR at 14440.

59 See id. at 14528.

is made available to the Commission in accordance with an agreement between the DTCC–TIW and the OTC Derivatives Regulators' Forum ("ODRF"), of which the Commission is a member.

The DTCC–TIW data provides sufficient information to identify the types of market participants active in the SBS market and the general pattern of dealing within that market. However, as the Commission noted in the SDR Adopting Release, the DTCC–TIW data does not encompass CDS transactions that both: (i) do not involve any U.S. counterparty, and (ii) are not based on a U.S. reference entity.[60] Furthermore, because counterparties to CDS transactions voluntarily submit data to DTCC-TIW to support commercial activities, the data are not necessarily suited to support the Commission's needs, the legal requirements underlying the rules (e.g., the Dodd-Frank Act) or regulatory needs. For example, the transaction records captured by DTCC–TIW allow the Commission to identify trade execution dates but do not provide data to determine trade execution times.[61] Both Regulation SBSR and the SDR Rules will assist the Commission in fulfilling its regulatory mandates such as detecting market manipulation, fraud, and other market abuses by providing it with access to more detailed SBS information than that provided under the voluntary reporting regime.

2. Swap Data Repositories

In the SDR Adopting Release, the Commission estimated that 10 persons may register with the Commission as SDRs.[62] The Commission notes that in the swap market, only four persons have been provisionally registered with the CFTC for regulatory reporting in the swap

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60 See SDR Adopting Release, 80 FR at 14445.

61 See Memorandum by the Staffs of the Division of Trading and Markets and the Division of Economic and Risk Analysis of the U.S. Securities and Exchange Commission, Inventory risk management by dealers in the single-name credit default swap market (Oct. 17, 2014), available at http://www.sec.gov/comments/s7-34-10/s73410-184.pdf.

62 See SDR Adopting Release, 80 FR at 14521.

market as SDRs thus far: BSDR LLC, Chicago Mercantile Exchange, Inc., DTCC Data Repository, and ICE Trade Vault.[63] BSDR LLC and DTCC Data Repository currently allow reporting participants to submit transaction data using FpML.[64] Intercontinental Exchange, the parent of ICE Trade Vault, uses FpML,[65] while Chicago Mercantile Exchange, Inc. allows reporting participants to submit transaction data using FIXML.[66] Accordingly, the Commission continues to preliminarily believe that approximately 10 persons would register with the Commission as SDRs.

3. FIXML and FpML

As previously discussed in Section II.A, there are two international industry standards for representing SBS data: FpML and FIXML.[67] Both are open standards, meaning that they are technological standards that are widely available to the public at no cost. In addition, both standards are independent of the software and hardware used by market participants, thus facilitating interoperability. Representatives from the financial industry, including those in the

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63 See U.S. Commodity Futures Trading Commission, Swap Data Repository Organizations, http://sirt.cftc.gov/sirt/sirt.aspx?Topic=DataRepositories (last visited Dec. 8, 2015).

64 See Bloomberg Swap Data Repository, BDSR APIs, http://www.bloombergsdr.com/api (describing trade submission methods available to participants reporting to BDSR) (last visited Dec. 8, 2015). See also DTCC, US DDR SDR, http://www.dtcc.com/data-and-repository-services/global-trade-repository/gtr-us.aspx (describing submission formats supported by DTCC Data Repository) (last visited Dec. 8 2015).

65 See ISDA FpML Survey Annex 1 (January 2011), http://www.isda.org/media/press/2011/pdf/isda-fpml-user-survey.pdf (listing ICE as an FpML user).

66 See CME Group, Submitting Trades to the CME Swap Data Repository, http://www.cmegroup.com/trading/global-repository-services/submitting-trades-to-cme-repository-service.html (detailing data submission requirements for the CME Swap Data Repository) (last visited Dec. 8, 2015).

67 The Commission is aware that market participants may also use proprietary XML representations of transactions data.

SBS market, and market participants are involved in maintaining, developing, and updating both standards to support, among other things, market practices and regulatory reporting requirements. FpML maintenance is undertaken by the FpML Standards Committee, which is made up of representatives from a range of financial market participants including banks, brokers, CCPs, and other financial infrastructure providers. FIX is owned, maintained, and developed through the collaborative efforts of the FIX Trading Community, which is a non-profit, industry-driven standards body comprised of over 270 member firms from the global financial services industry.[68]

Based on the fact that there is substantial industry involvement in the development of both standards, the Commission preliminarily believes that the majority of transactions reportable under Regulation SBSR would include at least one counterparty that is familiar with communicating transaction details using FpML or FIXML or currently supports such communication. Further, most market participants will have familiarity with using FpML and/or FIXML for transaction reporting, including reporting to meet reporting obligations under the rules of other jurisdictions. For example, the FpML Regulatory Reporting Working Group has developed a draft mapping document that relates data elements required by seven regulators other than the Commission, in various jurisdictions, to corresponding FpML fields.[69] The FIX Community has similarly provided documentation to show how data represented in FIX

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68 Updates to FpML are regularly announced at www.fpml.org, while updates to the FIX protocol, including updates to FIXML are regularly announced at http://www.fixtradingcommunity.org/pg/structure/tech-specs/fix-protocol (last visited Dec. 8, 2015).

69 See supra note 26.

corresponds to certain regulatory reporting requirements.[70] These efforts provide evidence that the groups responsible for developing FIX and FpML are already responding to regulatory reporting requirements by updating their reporting elements, and that market participants that use these standards would likely be able to use these standards to discharge reporting obligations.

As noted in Section II.B.1, the schemas would include data elements that correspond to concepts defined in Rule 900 and required to be reported to registered SDRs by Rule 901. It would also include certain data elements derived from obligations of registered SDRs under Rule 907. Based on a mapping exercise conducted by Commission staff, the Commission preliminarily believes that both the FpML and FIMXL reporting standards already include defined data elements that can be used to cover many of the concepts in the common data model. However, the Commission staff has identified several instances of concepts within the proposed common data model that do not yet have equivalently defined data elements in FpML or FIXML. In those cases, the schemas published on the Commission's website would provide extensions of existing FpML and FIXML reporting elements. To the extent that the FpML and FIXML standards address the common data model as part of their periodic updates, the Commission expects that the standards will create defined elements to replace the initial use of extensions. If the Commission were to adopt a rule that required SDRs to make SBS data available to the Commission using the FpML or FIXML standards, the Commission anticipates that its staff would keep apprised of relevant advances and developments with those standards and engage with each standard's working group regarding such developments, as appropriate.

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70 See, e.g., FIX Protocol, Limited, Global Technical Committee and Futures Industry Association, CFTC Part 43 & 45 Gap Analysis III Foreign Exchange, (Jan. 3, 2013), available at http://www.fixtradingcommunity.org/mod/file/view.php?file_guid=46985.

## B. **Benefits**

The Commission preliminarily believes that the proposed amendment, by specifying the form and manner with which SDRs would be required to make SBS data available to the Commission, provide for the accurate analysis of data made available by a single SDR, and the aggregation and analysis of data made available by multiple SDRs. In particular, the proposed amendment would enable the aggregation of SBS data by the Commission.

In the SDR Adopting Release, the Commission recognized that the benefits associated with SDR duties, data collection and maintenance, and direct electronic access may be reduced to the extent that SBS market data are fragmented across multiple SDRs.[71] Fragmentation of SBS market data may impose costs on any user of this data associated with consolidating, reconciling, and aggregating this data. Without a common data model expressed in specific formats, SDRs might, for example, make available to the Commission SBS data that are formatted using a variety of standards including FpML, FIXML, or other distinct proprietary standards or methods. Such an outcome could significantly increase the complexity of data aggregation, or perhaps even render data aggregation impractical because the Commission would have to map each standard to the common data model and might need to transform data from each SDR to meaningfully aggregate data across SDRs. Adding to the complexity of data aggregation, the Commission would have to repeat the mapping exercise and update data transformations each time an SDR chooses to update its standard, which could be disruptive to the Commission's monitoring and surveillance efforts.

By limiting SDRs' flexibility to a choice between FpML and FIXML, the Commission seeks to facilitate data aggregation and analysis by specifying the form and manner with which

[71] See SDR Adopting Release, 80 FR at 14538.

SDRs would be required to make SBS data available to the Commission. Adherence by SDRs to the schemas when providing direct electronic access should enhance the Commission's ability to analyze the data maintained by a single SDR, and allow the Commission to more effectively aggregate and analyze data received from multiple SDRs. Furthermore, the proposed amendment also simplifies the aggregation task because the Commission would determine the permitted formatting standards and schemas, not the SDRs. As a result, the process of data aggregation will not be complicated or disrupted by SDRs' decisions to update their formatting standards for reasons unrelated to regulatory requirements. The proposed amendment affords a simpler data aggregation process compared to an alternative in which SDRs exercise full discretion over the choice of formatting standard for providing direct electronic access and the timing for using the chosen standard.

As discussed above, the schemas would incorporate validations.[72] These validations are restrictions placed on the form and manner of the SBS data made available by SDRs to the Commission that help ensure that the data SDRs make available to the Commission adhere to the appropriate schema. In particular, the validations test whether the data are complete and appropriately formatted and will likely enhance the Commission's ability to normalize and aggregate the data. While validations incorporated into the schemas will be effective for checking data completeness and appropriate formatting, schema validations will not test for whether the SBS data accurately reflects the transaction that took place.

The proposed amendment may also indirectly improve the quality of regulatory reporting in a number of ways. First, by specifying the form and manner with which SDRs must make SBS data available to the Commission, the proposed amendment might provide SDRs an

[72] See Section II.C.3 of this release.

incentive to limit the range of ways that their participants can report SBS transaction data to them. If the proposed amendment results in clearer policies and procedures of registered SDRs, then the result could be more efficient reporting. Second, by leveraging existing industry standards, the proposed amendment may indirectly improve SBS data quality by eliminating the need for SDRs to reformat data already structured in FpML or FIXML in some different Commission specific format, thus reducing the likelihood that SDRs introduce errors in the process of reformatting data.

### C. Costs

The Commission has preliminarily identified three potential sources of costs associated with the proposed amendment. The first potential source is SDRs' implementation of the proposed amendment, the second potential source is the extension of existing standards to meet the Commission's reporting requirements and the updating of those standards if necessary, and the third potential source arises from limiting the flexibility of SDRs in making SBS data available to the Commission.

#### 1. Implementation cost to SDRs

As the Commission noted in the SDR Adopting Release, the cost imposed on SDRs to provide direct electronic access to the Commission should be minimal as SDRs likely have or will establish comparable electronic access mechanisms to enable market participants to provide data to SDRs and review transactions to which such participants are parties.[73] Further, as the Commission noted in Section III.A, many of the entities likely to register with the Commission as SDRs already accept transactions data from reporting persons who submit trade information using the FpML and FIXML standards.

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73 See SDR Adopting Release, 80 FR at 14539.

Nevertheless, the Commission acknowledges that, as a result of the proposed amendment, SDRs may decide to implement policies, procedures, and information systems to ensure that SBS data made available to the Commission is in a form and manner that satisfies the requirements laid out in the schemas. The Commission preliminarily believes that the costs of implementing such policies, procedures, and information systems are likely to be related to conforming their data models to one of the Commission's schemas and are likely to be smaller for those SDRs that already employ FIXML or FpML. The Commission preliminarily believes that these costs, which are in addition to the internal costs related to information technology systems, policies, and procedures the Commission estimated in the SDR Adopting Release,[74] would be approximately \$127,000 in one-time costs per SDR, on average,[75] for an expected aggregate one-time cost of approximately \$1,270,000.[76] To arrive at these estimates, we assume that each SDR

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74 See id.

75 The Commission preliminarily estimates that an SDR will assign responsibilities for modifications of information technology systems to an Attorney, a Compliance Manager, a Programmer Analyst and a Senior Business Analyst and responsibilities for policies and procedures to an Attorney, a Compliance Manager, a Senior Systems Analyst and an Operations Specialist. Data from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead, suggest that the cost of a Compliance Manager is \$283 per hour, a Programmer Analyst is \$220 per hour, a Senior Systems Specialist is \$260 per hour, a Senior Business Analyst is \$251 per hour, and an Operations Specialist is \$125 per hour. Thus, the total initial estimated dollar cost will be \$126,736.50 per SDR. This reflects the sum of the costs of modifying information technology systems (\$110,810) and the cost of modifying policies and procedures (\$15,926.50). Costs of modifying information technology systems are calculated as follows: (Attorney at \$380 per hour for 70 hours) + (Compliance Manager at \$283 per hour for 80 hours) + (Programmer Analyst at \$220 per hour for 200 hours) + (Senior Business Analyst at \$251 per hour for 70 hours) = \$110,810. Costs of modifying policies and procedures are calculated as follows: (Attorney at \$380 per hour for 21.75 hours) + (Compliance Manager at \$283 per hour for 19.25 hours) + (Senior Systems Analyst at \$260 per hour for 5.75 hours) + (Operations Specialist at \$125 per hour for 5.75 hours) = \$15,926.50.

76 Aggregate costs are calculated as \$126,736.50 x 10 SDRs = \$1,267,365.

will first compare the data model it currently employs to the common data model represented by the schemas and subsequently make necessary modifications to information technology systems and policies and procedures.

To the extent that SDRs decide to modify their policies, procedures, and information technology systems, the Commission preliminarily believes that modifications that would be needed to support compliance with the proposed amendment are unlikely to change the marginal burden of providing direct electronic access to transaction records to the Commission. This is because the only additional costs would be costs incurred by SDRs to use policies, procedures, and information systems they would have already established to ensure that each additional transaction record that is made available to the Commission is in a form and manner that meets the requirements of the schemas.

The Commission also preliminarily believes that certain of these costs may be mitigated to the extent that the proposed amendment promotes enhancements to FpML and FIXML in support of regulatory reporting to registered SDRs. If the schemas, by identifying and closing gaps between reporting requirements and existing standards, encourage the use of FpML and FIXML by reporting persons instead of other formatting standards, then SDRs could incur a lower burden of conforming SBS data to one of the Commission's schemas because SDRs will be limited to FpML or FIXML when making the data available to the Commission.

The Commission recognizes that while SDRs may directly bear the implementation costs discussed above, these costs may be shared among market participants other than SDRs in several ways and will likely be passed through to SBS market participants, potentially in the form of higher costs for participants of registered SDRs, which in turn could result in higher transactions costs for counterparties, potentially impairing, albeit indirectly, efficiency in the

SBS market and capital formation by SBS market participants. For example, the implementation costs incurred by registered SDRs could be passed on to reporting participants in the form of higher fees for reporting transactions. Consider the situation in which a registered SDR takes on reporting participants as clients before it implements the policies, procedures, and information systems needed to ensure that SBS data made available to the Commission is in a form and manner that satisfies the requirements laid out in the schemas. This registered SDR could offset this implementation cost by levying higher service charges on its participant base.

The ability of SDRs to pass through costs to their participants depends in part on the market power of SDRs. As discussed in the economic baseline, the Commission preliminarily believes that a limited number of persons would register with the Commission as SDRs. If there is only one registered SDR serving all reporting participants, then this SDR would have a greater ability to shift implementation costs that could arise as a consequence of the proposed amendment to its users. By contrast, a competitive SDR industry would likely mean that registered SDRs had less market power, rendering them less able to pass through such costs to reporting participants.

As an alternative to imposing higher fees on participants, registered SDRs could pass through a portion of the implementation costs to their participants by requiring reporting parties to report SBS data using FpML or FIXML in the same manner that the Commission is proposing to require that SDRs utilize for making data accessible to the Commission under the Commission's schemas. Under Rule 907(a)(2), a registered SDR is required to establish and maintain written policies and procedures that specify one or more acceptable data formats (each of which must be an open-source structured data format that is widely used by participants), connectivity requirements, and other protocols for submitting information. In response to the proposed amendment, registered SDRs might elect to establish policies and procedures that would facilitate conforming transaction data submitted by reporting participants to the schemas, pursuant to which the registered SDRs would be required to make the data accessible to the Commission. In particular, a registered SDR might elect to establish policies and procedures that mandate reporting of data elements under Rules 901(c) and 901(d) in the same form and manner that the Commission is proposing to require of registered SDRs, or levy fees for reformatting SBS transaction data reported in other formats to conform to one of the schemas. In this scenario, the registered SDR's participants could incur costs associated with: (i) modifying their reporting systems to transmit data to the registered SDR in a FIXML or FpML format that conforms to one of the schemas; or (ii) the registered SDR's reformatting of data to conform to one of the schemas. The registered SDR could subsequently make the data available to the Commission with minimal resources in ensuring that the data conforms to one of the schemas.

Efficiency in the SBS market and capital formation by SBS market participants may be impaired, albeit indirectly, by registered SDRs' decisions to require reporting parties to report SBS data using FpML or FIXML under the Commission's schemas. If the technologies required to implement the proposed amendment have scale economies, then an outcome in which reporting participants independently modify their reporting systems potentially represents an inefficient use of resources for the SBS market as a whole, even if it results in lower costs to SDRs, and particularly if reporting participants that do not otherwise have a frequent duty to report also modify their reporting systems. While acknowledging the potential for these inefficiencies, the Commission preliminarily believes they are unlikely to manifest for a number of reasons. First, because FpML and FIXML are currently international industry standards,[77] it is likely that a significant proportion of reporting participants already use either FpML or FIXML. Participants with reporting obligations include SBS dealers; the Commission has also proposed reporting obligations for clearing agencies.[78] Commission staff has determined that all four clearing agencies currently clearing index and single name CDS use either FpML or FIXML,[79] and at least fourteen of the fifteen major dealers recognized by ISDA use either FpML or FIXML[80]. Reporting participants that already use FpML or FIXML could potentially adapt policies, procedures, and information systems to report transactions using one of the schemas at a

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77 See Sections II.A.1 and III.A of this release.

78 See Regulation SBSR Adopting Release, 80 FR at 14730. See also Securities Exchange Act Release No. 74245 (February 11, 2015), 80 FR 14740, 14802 (March 19, 2015) ("SBSR Amendments Proposing Release").

79 ICE Clear Credit, ICE Clear Europe, CME, and LCH.Clearnet currently clear index and single name CDS. See SBSR Amendments Proposing Release 80 FR at 14775. Section III.A.2 of this release discusses the formatting standards used by ICE and CME. LCH.Clearnet allows reporting participants to submit transactions data using FpML. See LCH.Clearnet Ltd, ClearLink Messaging Specification 4 (June 2013), available at http://www.lchclearnet.com/documents/515114/515787/Clearlink+Technical+Requirements/004bb402-1b77-4561-88d7-c0e7e90b7363.

80 The fifteen major derivatives dealers identified in the 2013 ISDA Operations Benchmarking Survey are Barclays Capital, BNP Paribas, Bank of America-Merrill Lynch, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Morgan Stanley, Nomura, Royal Bank of Scotland, Societe Generale, UBS, Wells Fargo. See International Swaps and Derivatives Association, Inc., 2013 ISDA Operations Benchmarking Survey 29 (Apr. 2013), available at https://www2.isda.org/attachment/NTUzOQ==/OBS%202013%20FINAL%200425.pdf.

We use the FIX Trading Community Membership listing to identify dealers that use FIXML. See Premier Global Members, http://www.fixtradingcommunity.org/pg/group-types/sellside-broker-dealers-public (last visited Dec. 8, 2015). We rely on a dealer's membership in the FpML Standards Committee as an indication of the dealer's use of FpML. See Standards Committee, http://www.fpml.org/committees/standards/ (last visited Dec. 8, 2015). Because both the FIX Membership listing and FpML Standards Committee participation are voluntary, our estimates present a lower bound of the number of major dealers that use either FpML or FIXML.

lower cost than reporting participants that use a standard other than FpML or FIXML. Second, the potential inefficiencies may be muted if there are multiple SDRs that accept SBS data in each asset class. To the extent that multiple SDRs compete within an asset class, one potential competitive outcome is that one or more SDRs may strive to attract business from reporting participants by exploiting the scale economies associated with implementation and offering to accept data in whatever formats they currently accept from reporting participants and reformatting this data to conform to the common data model. In the case of a registered SDR that chooses to levy a fee for reformatting SBS data to conform to one of the schemas, competition between SDRs may limit the fees an SDR has the ability to charge.

Taken together, scale economies for implementation and competition among SDRs might compel all SDRs to permit reporting participants to submit SBS data to SDRs using a variety of formats, thereby eliminating the inefficiencies associated with modification of systems by reporting parties.

Finally, participants that report infrequently or do not use FpML or FIXML could reduce their burden by engaging with third-party entities to carry out reporting duties incurred under Regulation SBSR as well as satisfy data formatting requirements specified by registered SDRs.[81] Third-party entities may offer reporting services if they are able to make SBS data available in a form and manner consistent with the schemas at a lower cost than SDRs and SDR participants. Such a cost advantage might arise if a third-party entity uses FpML or FIXML to process SBS data as part of its existing business activities and has acquired technical expertise in using FpML

[81] The Commission acknowledged in Regulation SBSR that reporting requirements could present a barrier to entry for smaller firms but noted that firms that are reluctant to acquire and build reporting infrastructure could engage with third-party service providers to carry out reporting duties under Regulation SBSR. See Regulation SBSR Adopting Release, 80 FR at 14702.

or FIXML. Further, the availability of third-party entities that can convert SBS data to meet formatting requirements specified by registered SDRs may place an upper limit on the fees levied by SDRs to reformat data to conform to a Commission schema.

2. Costs of extending and updating standards

At present, FpML and FIXML do not have a complete set of defined reporting elements that address all Regulation SBSR reporting requirements. Market participants may choose to extend these standards to fully reflect Regulation SBSR reporting requirements through the industry bodies that maintain FpML and FIXML (working groups).[82] As discussed earlier, both standards undergo regular updates.

While the Commission acknowledges the costs of extending and updating these standards, these are indirect costs, in that they are not costs required to be incurred by the proposed amendment, but costs that may be incurred voluntarily by industry bodies. Further, the Commission preliminarily believes that extension costs would be modest. An analysis

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82 The FIX Protocol is updated by actions of its Global Technical Committee via a formal process in which working groups formulate a gap analysis and technical proposal. The gap analysis and proposal documents are posted on the FIX web site and accessible to the public prior to Global Technical Committee review. Approved proposals are published to the technical specification page as an "extension" or "errata/service" release, depending on their scope. Extensions to the FIX protocol apply to both FIX's native format and FIXML. See FIX Protocol, Limited, FPL Technical Gap Analysis Approval Process (Jan. 20, 2006), available at http://www.fixtradingcommunity.org/pg/file/fplpo/read/1437402/gap-analysis-specification-proposal-process.

FpML is updated by actions of its Standards Committee via a formal process in which working groups produce documents that define extensions or other technical matters which must proceed through stages as working drafts, last call working drafts, trial recommendations and recommendations. Extensions to FpML that reach trial recommendation status are assigned an incremented version number, so that the latest recommendation may be FpML 5.7 while the trial recommendation is FpML 5.8. All public specifications are published on the FpML web site. See FpML Standards Committee, Standards Approval Process – Version 2.1 – June 2009, available at http://www.fpml.org/asset/49a6b038/7545553a.pdf.

undertaken by Commission staff suggests that each standard currently has the defined reporting elements required to capture almost all of the data elements contemplated by Regulation SBSR.[83] The Commission also preliminarily believes that the update costs would be limited because any update needed to support possible future changes in Regulation SBSR reporting requirements would likely be implemented as part of the routine updates undertaken by the working groups. The Commission reviewed the time taken to revise both FpML and FIXML and estimated that a revision requires on average 304 days.[84] A working group is estimated to be 29-member strong based on the size of the working group charged with revising FpML to define data elements to be used for reporting OTC derivative positions between market participants and to regulators.[85] The Commission assumes that the one-time extension and a periodic update of each standard will require only a fraction of the time required for a revision of a standard, with an extension requiring more time than a periodic update. Thus, the one-time cost of extending each standard is estimated to be $1,410,560 for a total cost of $2,821,120 for both standards, while the cost of a periodic update to one standard is estimated to be $282,112 for a total cost of $564,224 for both

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83 See Section II.C and Appendix.

84 Using the release dates for versions 4.1 through 5.7 of FpML, we estimate the average time taken to update each version to be 154 days. Using the release dates for versions 4.0 through 5.0 of FIXML, we estimate the average update time to be 454 days. We take the average of these two estimates to arrive at the final estimate of 304 days. The Commission preliminarily believes that these estimates are upper bounds on the time required to make extensions as a result of the proposed amendment because they represent an average of major and minor changes and because these changes likely represent a mix of changes in response to market practice and changes in response to regulatory requirements.

85 See Section III.A.3 of this release. See also FpML, Regulatory Reporting Working Group, http://www.fpml.org/wgroup/rptwg/ (last visited Dec. 8, 2015).

standards.[86] The Commission preliminarily believes that, while these costs would be directly incurred by working group members, they would likely be passed through to market participants, potentially in the form of higher transactions costs.

3. Limiting formatting flexibility of SDRs

In the SDR Adopting Release, the Commission required SDRs to provide direct electronic access, but did not specify the form and manner of the direct electronic access. As the Commission noted in the SDR Adopting Release, until such time as the Commission adopts specific formats and taxonomies, "SDRs may provide direct electronic access to the Commission to data in the form in which the SDRs maintain such data."[87] The proposed amendment, by specifying the form and manner of direct electronic access, potentially curtails the flexibility in formatting choices that SDRs enjoy in the absence of the proposed amendment. The Commission is aware that such curtailment potentially represents a cost of the proposed amendment, but does not believe it can quantify this cost with any degree of precision as it depends on the different means by which each SDR could potentially make data available to the Commission electronically in the absence of the proposed amendment.

Additionally, the proposed amendment could entail costs if FpML and FIXML no longer reflect SBS market conventions. As the SBS market evolves, FpML and FIXML may cease to

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86 Because members of a working group are professionals from various organizations, we treat each member as an outside professional for this analysis and use a $400 per hour cost. We assume an eight hour work day for each member of the working group. For the one-time extension of a standard, we assume a workload of 5% of each working group member's work day. Given these assumptions, the cost of extending one standard = 304 x 29 x 8 x 400 x 0.05 = $1,410,560. The cost of extending both standards is = 1,410,560 x 2 = $2,821,120. For the periodic update of a standard, we assume a workload of 1% of each working group member's work day due to the incremental and limited nature of a periodic update. Thus, the cost of a periodic update to one standard = 304 x 29 x 8 x 400 x 0.01 = $282,112, and the cost for both standards is = 282,112 x 2 = $564,224.

87 See SDR Adopting Release, 80 FR at 14475.

reflect SBS market practices or products. If more efficient standards other than FpML or FIXML emerge, the proposed amendment would not permit SDRs to take advantage of those standards in providing direct electronic access to the Commission, though the proposed amendment would not preclude SDRs from using those standards for other purposes. The magnitude of this economic effect is difficult to estimate as we would require information about future SBS market practices and products, as well as efficiency improvements in currently existing and new formatting standards. Moreover, the Commission preliminarily believes that potential reductions in future flexibility will be limited for a number of reasons. First, as previously discussed in Section II.A, representatives from the financial industry, including those in the SBS market, are involved in maintaining, developing, and updating FpML and FIXML to support, among other things, market practices and regulatory reporting requirements. Periodic updating reduces the likelihood that FpML and FIXML will fail to reflect changes to SBS market practices or products. Further, the Commission preliminarily believes that industry involvement and periodic updating make it less likely that a more efficient alternative to FpML or FIXML will emerge. Second, by specifying schemas based on both FpML and FIXML, the proposed amendment provides redundancy in case one standard falls into disuse and no longer reflects SBS market practices or products.

### D. Competition among SDRs

The Commission is also sensitive to the effects on competition among SDRs that might arise as a result of the proposed amendment. The Commission preliminarily believes that the impact of the proposed amendment is likely to be limited. The Commission views the effect of the proposed amendment as further specifying the form and manner of data already required to be made available to the Commission under Rule 13n-4(b)(5). The Commission understands that the implementation costs associated with meeting minimum requirements for form and manner under the proposed amendment could represent a barrier to entry for entrants into the SDR industry that, in the absence of the proposed amendment, would choose to make data available to the Commission in a lower cost form and manner.

To the extent that the proposed amendment deters new firms from entering the SDR industry, competition between SDRs could be reduced. A less competitive SDR industry could see incumbent registered SDRs increasing fees charged to reporting participants, reducing the quantity and quality of services provided to reporting participants, or both. Further, a less competitive SDR industry could make it easier for incumbent registered SDRs to shift a bigger portion of their implementation cost to reporting participants. As noted above, such a shift could represent an inefficient allocation of implementation costs if it results in duplicative investment in software and systems by a large number of reporting parties to conform data to the schemas.[88]

The Commission preliminarily believes that any deleterious effect on competition that results from the proposed amendment might be limited for a number of reasons. First, because the Commission is selecting the FpML and FIXML standards which are widely available to the public at no cost, new entrants would not incur any cost associated with the creation of new standards. Second, should extension and updating costs be necessary, such costs are expected to be modest and would likely be shared among various market participants, including SDRs. Thus, the actual portion of these costs incurred by a new entrant would be limited.

### E. <u>Alternative Approaches</u>

The Commission has considered two alternatives to the approach contemplated in the proposed amendment. In this section, we discuss each alternative in turn and the reasons why each alternative approach was not proposed.

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[88] See Section III.C.1 of this release.

1. Developing a new standard

The first alternative would involve development of a new information formatting standard specifically designed to support regulatory reporting of SBS data. The Commission could implement this alternative in one of two ways. First, the Commission could develop a new standard on its own and require SDRs to use this standard. The key advantage of such an approach is that it would give the Commission the ability to tailor definitions of data elements to precisely match those in Regulation SBSR. However, this approach suffers from a number of drawbacks. The Commission would likely expend significant resources to (i) develop an information formatting standard for SBS data, (ii) stay informed of the various practices of the SDRs, (iii) provide guidance on the standard's use, and (iv) update the standard on a regular basis to incorporate innovations in the SBS market and additional reporting requirements as determined by future Commission action. Further, under this approach market participants could incur costs associated with supporting an additional information formatting standard that is not useful except for purposes of satisfying Title VII requirements.

In the absence of an existing standard for SBS data, it would be appropriate for the Commission to develop a new standard specifically designed to support regulatory reporting of SBS data. However, because FpML and FIXML are existing standards that are widely used by market participants, the Commission preliminarily believes it would be more efficient to leverage these standards that have been designed with input from market participants, that communicate information about financial contracts, and that can be updated and maintained with the assistance of dedicated industry working groups. Further, the Commission preliminarily believes that the proposed approach reduces the likelihood that SDRs introduce errors to SBS data in the process of reformatting data structured in FpML or FIXML to conform to a new standard developed specifically for regulatory reporting. Thus, the Commission has not chosen to develop its own standard in the proposed amendment.

2. Using FpML or FIXML as the sole schema standard

A second alternative would be to use either FpML or FIXML as the sole schema standard. The Commission preliminarily believes that using only a single standard would impose an additional burden on an SDR that currently uses a standard other than the selected standard. Because FpML and FIXML are both widely used and accepted in the financial industry, it is possible that some SDRs use FpML while others use FIXML. As noted in the economic baseline, among the persons that could potentially register as SDRs for security-based swaps, BSDR LLC, DTCC Data Repository, and ICE are FpML users, while Chicago Mercantile Exchange, Inc. is a FIXML user. By selecting either FpML or FIXML as the sole standard, the Commission would be requiring an SDR that did not use the proposed standard to incur costs to change its policies, procedures, and information systems to accommodate the proposed standard. In addition, selecting a sole standard could increase the likelihood of introducing errors to SBS data caused by an SDR that uses the non-permissible standard when reformatting its data to conform to the selected standard. A greater likelihood of errors could potentially reduce the quality of SBS data made available to the Commission. Further, allowing both FpML and FIXML instead of allowing just one of these standards would afford some measure of redundancy in case one standard falls into disuse (due, for example, to the cessation of industry support) and no longer reflects current market practices.

**F. Request for Comment**

The Commission seeks commenters' views and suggestions on all aspects of its economic analysis of the proposed amendment. In particular, the Commission asks commenters to consider the following questions:

- What additional information sources can the Commission use to calibrate the cost of setting up and implementing policies, procedures, and information systems to format and submit SBS transaction data in accordance with the Commission's schemas?
- What fraction of reporting participants already use FpML or FIXML to format SBS data?
- What fraction of reporting participants use proprietary XML representations of SBS?
- What additional information sources can the Commission use to calibrate (a) the cost of extending FpML and FIXML and (b) the cost of periodically updating these standards?
- Are there costs associated with the proposed amendment that the Commission has not identified? If so, please identify them and if possible, offer ways of estimating these costs.

## IV. Paperwork Reduction Act

The Commission is required to take into account those provisions of any proposed amendments that contain "collection of information requirements" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[89] In this release, the Commission is proposing to specify the form and manner with which SDRs will be required to make SBS data available to the Commission under Exchange Act Rule 13n-4(b)(5). Specifically, the Commission is proposing to amend Rule 13n-4(a)(5) to require SDRs to provide direct electronic access using either the FpML schema or the FIXML schema as published on the Commission's website. The Commission is also requiring that the SDRs use the most recent schema published on the website, as the Commission may make periodic updates to reflect changes in the FpML and FIXML standards or changes in industry practice.

89 44 U.S.C. 3501 et seq.

As is discussed in greater detail below, the Commission preliminarily believes that the proposed amendments to Rule 13n-4(a)(5) would result in a collection of information burden. To the extent that this collection of information burden has not already been accounted for in the adoption of the SDR Adopting Release and Regulation SBSR,[90] such burden is discussed below. The purpose of the proposed amendments to Rule 13n-4(a)(5) is to specify the form and manner with which SDRs would be required to make SBS data available to the Commission. By doing so, the Commission seeks to ensure that the SBS data made available by SDRs are formatted and structured consistently so that the Commission can accurately analyze the data maintained by a single SDR, and so that the Commission can also aggregate and analyze data maintained by multiple SDRs. Collection of the underlying data, however, is already covered by existing collections.

The Commission's SDR Rules (OMB Control Number 3235-0719) consist of Rules 13n-1 to 13n-12 under the Exchange Act governing SDRs, and a new form, Form SDR, for registration as a security-based swap data repository. Among other things, Rule 13n-4(b) sets forth requirements for collecting and maintaining transaction data that each SDR will be required to follow. The SDR Adopting Release described the relevant burdens and costs that complying with Rule 13n-4(b), as well as the other companion rules, will entail. The Commission estimated that the one-time start-up burden relating to establishing the systems necessary to comply to the SDR Rules (including Rule 13n-4(b)) would be 42,000 hours and $10 million in information technology costs for each SDR, for a total one-time start-up burden of 420,000 hours and $100

90 See SDR Adopting Release, 80 FR 14437; Regulation SBSR Adopting Release, 80 FR 14673.

million.[91] The Commission further estimated that the average ongoing annual burden of these systems would be 25,200 hours and $6 million per SDR, for a total annual ongoing annual burden of 252,000 hours and $60 million.[92] The Commission preliminarily believes that there would be additional burdens on top of those already discussed in connection with the SDR Rules as a result of the proposed amendments. The Commission is submitting the collection of information to the Office of Management and Budget for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. The title of the collection of information the Commission is proposing to amend is "Form SDR and Security-Based Swap Data Repository Registration, Duties, and Core Principles." 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.

Regulation SBSR (OMB Control No. 3235-0718), among other things, sets forth the primary and secondary SBS trade information that must be reported to a registered SDR and, with some exceptions, disseminated by a registered SDR to the public. The burdens associated with the reporting and dissemination of SBS trade information are discussed in Regulation SBSR. These burdens include those related to a registered SDR to time-stamping information that it receives, assigning a unique transaction ID to each security-based swap it receives (or establishing or endorsing a methodology for transaction IDs to be assigned by third parties), disseminating transaction reports related to SBSs, issuing notifications regarding closing hours and system availability, establishing protocols for correcting errors in SBS information, obtaining UICs as necessary, establishing and maintaining compliance with certain policies and procedures, and registering as a securities information processor. In this release, the

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91 See 80 FR at 14523.

92 Id.

Commission has not proposed changes to the information that must be reported to a registered SDR or the information that must be disseminated by a registered SDR to the public. The Commission therefore preliminarily believes that there would be no additional burden beyond those already discussed in connection with Regulation SBSR.

The Commission believes, as is discussed in greater detail above in Section II.A., that the participants in the SBS market generally already employ two industry standard formats: FpML and FIXML. The Commission expects, but Regulation SBSR does not require, that registered SDRs will accept SBS trade information in one or both of these industry standard formats. In preparation for compliance with Regulation SBSR and the SDR Adopting Release, the Commission expects that registered SDRs will have established systems capable of collecting – and indeed likely have already collected SBS trade information – in one of these two industry standards formats. However, the Commission does acknowledge that, as a result of the proposed amendment, SDRs may incur burdens associated with implementing policies, procedures, and information systems to ensure that SBS data made available to the Commission is in the form and manner that satisfies the requirements laid out in the schema.

### A. Summary of Collection of Information

Rule 13n-4(b)(5) requires SDRs to provide direct electronic access to the Commission or its designees. Rule 13n-4(a)(5), as proposed to be amended, requires "direct electronic access" to be made using "the most recent version of either the FpML schema or the FIXML schema for security-based swap data repositories as published on the Commission's website." The proposed amendments do not alter or amend the information that must be collected and maintained by a registered SDR, but do impact the manner in which such information is made available to the Commission.

### B. Use of Information

Rules 13n-4(b)(5) requires that an SDR provide the Commission, or any designee of the Commission, with direct electronic access. The information made available to the Commission, or its designee, will help ensure an orderly and transparent SBS market as well as provide the Commission with tools to help oversee this market.

### C. Respondents

The direct electronic access requirements of Rule 13n-4(b)(5) apply to all SDRs, absent an exemption. Thus, for these provisions, the Commission continues to estimate that there will be 10 respondents.

### D. Total Initial and Annual Reporting and Recordkeeping Burden

As discussed above, Rule 13n-5(b)(5) requires SDRs to provide direct electronic access to the Commission or its designees. Rule 13n-4(a)(5), as proposed to be amended, would require "direct electronic access" to be made available to the Commission using "the most recent version of either the FpML schema or the FIXML schema for security-based swap data repositories as published on the Commission's website."

The Commission preliminarily believes that registered SDRs are likely to already accept transaction data from reporting persons who submit trade information using FpML and FIXML reporting standards. However, the Commission preliminarily believes that, as a result of the proposed amendment, registered SDRs may incur certain burdens associated with implementing policies, procedures, and information systems to ensure that SBS data made available to the Commission is in a form and manner that satisfies the requirements laid out in the schemas. The Commission preliminarily believes that these incremental burdens are likely to be related to ensuring that the data elements that constitute the common data model are represented using the appropriate FIXML or FpML reporting elements and are likely to be smaller for those SDRs that already employ FIXML or FpML. The Commission preliminarily estimates that each registered SDR will incur an initial, one-time burden of 472.5 hours,[93] for an aggregate one-time burden of 4,725 hour for all registered SDRs.[94] The Commission expects that each SDR will comply with the proposed rule by first comparing the data model it currently employs to the common data model represented by the schemas and subsequently making necessary modifications to information technology systems and policies and procedures.

Once the policies, procedures, and information systems required to comply with the proposed amendment are in place, the Commission preliminarily does not believe that there will be any additional paperwork burden placed upon SDRs to make transaction records accessible in a form and manner that satisfies the requirements of the schemas. The Commission preliminarily believes that the burdens related to SDRs using their policies, procedures, and information systems they would have already established have been accounted for in the previously adopted SDR Rules. Furthermore, the Commission preliminarily believes that the annual burdens associated with maintaining the SDRs policies and procedures, as well as the annual burdens associated with modifications of information technology systems have already been accounted for in the previously approved SDR Rules.

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93 The Commission preliminarily estimates that an SDR will assign responsibilities for modifications of information technology systems to an Attorney, a Compliance Manager, a Programmer Analyst and a Senior Business Analyst and responsibilities for policies and procedures to an Attorney, a Compliance Manager, a Senior Systems Analyst and an Operations Specialist. The Commission estimates the burden of modifying information technology systems to be as follows: 70 hours (Attorney) + 80 hours (Compliance Manager + 200 hours (Programmer Analyst) + 70 hours (Senior Business Analyst) = 420 burden hours. The Commission estimates the burden of modifying policies and procedures to be as follows: 21.75 hours (Attorney) + 19.25 (Compliance Manager) + 5.75 hours (Senior Systems Analyst) + 5.75 hours (Operations Specialist) = 52.5 burden hours.

94 The aggregate burden is calculated as follows: (420 hours + 52.5 hours) x 10 registered SDRs = 4,725 burden hours

### E. Collection of Information is Mandatory

The collection of information relating to direct electronic access is mandatory for all SDRs, absent an exemption.

### F. Confidentiality

Because these proposed amendments do not impact the scope or nature of the information required to be made available to the Commission, the Commission does not expect to receive confidential information as a result of these proposed amendments. However, to the extent that the Commission does receive confidential information pursuant to this collection of information, such information will be kept confidential, subject to the provisions of applicable law.

### G. Recordkeeping Requirements

Rule 13n-7(b) under the Exchange Act requires an SDR to keep and preserve at least one copy of all documents, including all documents and policies and procedures required by the Exchange Act and the rules or regulations thereunder, correspondence, memoranda, papers, books, notices, accounts, and other such records as shall be made or received by it in the course of its business as such, for a period of not less than five years, the first two years in a place that is immediately available to representatives of the Commission for inspection and examination. This requirement encompasses any documents and policies and procedures established as a result of the proposed amendments.

### H. Request for Comments

Pursuant to 44 U.S.C. 3505(c)(2)(B), the Commission solicits comment to:

- Evaluate whether the proposed collection of information is necessary for the proper performance of our functions, including whether the information will have practical utility;

- Evaluate the accuracy of our estimate of the burden of the proposed collection of information;
- Determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and
- Evaluate whether there are ways to minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

Persons submitting comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should also send a copy of their comments to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street NE, Washington, DC 20549-1090, with reference to File Number S7-26-15. Requests for materials submitted to OMB by the Commission with regard to this collection of information should be in writing, with reference to File Number S7-26-15 and be submitted to the Securities and Exchange Commission, Office of FOIA/PA Operations, 100 F Street NE., Washington, DC 20549-2736. As OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication.

## V. Regulatory Flexibility Act Certification

Section 3(a) of the Regulatory Flexibility Act of 1980 ("RFA")[95] requires the Commission to undertake an initial regulatory flexibility analysis of the proposed amendment on

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[95] 5 U.S.C. 603(a).

"small entities." Section 605(b) of the RFA[96] provides that this requirement shall 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. Pursuant to 5 U.S.C. 605(b), the Commission hereby certifies that the proposed amendment to Rule 13n-4(a)(5) would not, if adopted, have a significant economic impact on a substantial number of small entities. In developing this proposed amendment the Commission has considered its potential impact on small entities. For purposes of Commission rulemaking in connection with the RFA, a small entity includes: (1) when used with reference to an "issuer" or a "person," other than an investment company, an "issuer" or "person" that, on the last day of its most recent fiscal year, had total assets of $5 million or less;[97] or (2) a broker-dealer with 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) under the Exchange Act,[98] or, if not required to file such statements, a broker-dealer with total capital (net worth plus subordinated liabilities) of less than $500,000 on the last day of the preceding fiscal year (or in the time that it has been in business, if shorter); and is not affiliated with any person (other than a natural person) that is not a small business or small organization.[99]

The Commission believes, based on input from SBS market participants and its own information, that persons that are likely to register as SDRs would not be small entities. Based on input from SBS market participants and its own information, the Commission believes that

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96 5 U.S.C. 605(b).

97 17 CFR 240.0-10(a).

98 17 CFR 240.17a-5(d).

99 17 CFR 240.0-10(c).

most if not all registered SDRs would be part of large business entities, and that all registered SDRs would have assets exceeding $5 million and total capital exceeding $500,000.

The Commission encourages written comments regarding this certification. The Commission solicits comment as to whether the proposed amendment to Rule 13n-4(a)(5) could have an effect on small entities that has not been considered. The Commission requests that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of such impact.

## VI. Small Business Regulatory Enforcement Fairness Act

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA)[100] the Commission must advise the OMB whether the proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results or is likely to result in: (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers or individual industries; or (3) significant adverse effect on competition, investment or innovation.

The Commission requests comment on the potential impact of the proposed amendment on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

## VII. Statutory Authority and Text of Proposed Amendment

Pursuant to the Exchange Act, and particularly Sections 13(n) and 23(a) thereof, 15 U.S.C. 78m(n) and 78w(a), the Commission is proposing to amend rule 13n-4(a)(5), under the Exchange Act.

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

**List of Subjects**

17 CFR Part 240

Reporting and recordkeeping requirements.

**Text of Proposed amendment**

For the reasons stated in the preamble, the SEC is proposing to amend Title 17, Chapter II of the Code of the Federal Regulations as follows:

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

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

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z–2, 77z–3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 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.

* * * * *

2. Revise § 240.13n-4(a)(5) to read as follows:

§ 240.13n-4 Duties and core principles of security-based swap data repository.

(a) * * *

(5) * * * Direct electronic access must be made available to the Commission using the most recent version of either the FpML schema or the FIXML schema for security-based swap data repositories as published on the Commission's website.

* * * * *

By the Commission.

Brent J. Fields
Secretary

December 11, 2015

APPENDIX: Mapping of common data model concepts to FIXML and FpML data elements

The common data model is informed by the current versions of the FpML and FIXML standards. Commission staff has mapped concepts in the common data model to existing data elements in both FpML and FIXML. Table 1 depicts the result of this mapping exercise for FpML version 5.9, which is considered current for the purposes of this proposal. Table 2 repeats this exercise for FIX version 5.0, Service Pack 2, which shall be considered current for the purposes of this proposal.

**Table 1: Mapping of common data model data concepts to FpML data elements. When the FpML column includes a list of terms, this means that FpML expresses the concept as a combination of data elements from that list. Blank entries mean that the concept does not presently have an exact equivalent in FpML.**

| § 901 Ref. | Common Data Model Concept | FpML Data Elements |
|---|---|---|
| (c)(1) | Product ID | productId |
| | | primaryAssetClass |
| | | secondaryAssetClass |
| | | productType |
| | | embeddedOptionType |
| (c)(1)(i) | Asset Class | primaryAssetClass |
| | | secondaryAssetClass |
| (c)(1)(i) | Underlying Reference Asset(s) | underlyingAsset |
| (c)(1)(i) | Underlying Reference Issuer(s) | referenceEntity |
| (c)(1)(i) | Underlying Reference Index | index |
| (c)(1)(ii) | Effective Date | effectiveDate |
| (c)(1)(iii) | Scheduled Termination Date | scheduledTerminationDate |
| (c)(1)(iv) | Terms of any standardized fixed rate payments | calculationPeriodAmount or fixedAmountCalculation |
| | | paymentDates |
| (c)(1)(iv) | Frequency of any fixed rate payments | calculationPeriodFrequency |
| (c)(1)(iv) | Terms of any standardized floating rate payments | calculationPeriodAmount |
| | | paymentDates |
| | | resetDates |
| (c)(1)(iv) | Frequency of any floating rate payments | calculationPeriodFrequency |
| (c)(1)(v) | Custom Swap Flag | nonStandardTerms |
| (c)(2) | The date and time, to the second, of execution, expressed using Coordinated Universal Time (UTC); | executionDateTime |
| (c)(3) | The price | quote |
| | | value |
| (c)(3) | The currency in which the price is expressed | currency |

| § 901 Ref. | Common Data Model Concept | FpML Data Elements |
|---|---|---|
| (c)(3) | The amount(s) of any up-front payments | additionalPayment<br>paymentType |
| (c)(3) | The currenc(ies) of any up-front payments | currency |
| (c)(4) | The notional amount(s) | notional<br>amount |
| (c)(4) | The currenc(ies) in which the notional amount(s) is expressed | currency |
| (c)(5) | Inter-Dealer Swap Flag | |
| (c)(6) | Intention To Clear Flag | intentToClear |
| (c)(7) | If applicable, any flags pertaining to the transaction that are specified in the policies and procedures of the registered SDR to which the transaction will be reported | |
| (d)(1) | The counterparty ID [on the reporting side] | onBehalfOf<br>partyId |
| (d)(1) | The execution agent ID [on the reporting side], as applicable | partyId<br>partyRole |
| (d)(1) | The counterparty ID [on the non-reporting side] | partyId<br>partyRole |
| (d)(1) | The execution agent ID of each counterparty, as applicable | partyId<br>partyRole |
| (d)(1) | [As applicable] the branch ID of the direct counterparty on the reporting side | relatedBusinessUnit<br>role |
| (d)(1) | [As applicable] the broker ID of the direct counterparty on the reporting side | relatedBusinessUnit<br>role |
| (d)(1) | [As applicable] the execution agent ID of the direct counterparty on the reporting side | relatedBusinessUnit<br>role |
| (d)(2) | [As applicable] the trader ID of the direct counterparty on the reporting side | relatedBusinessUnit<br>role |
| (d)(2) | [As applicable] the trading desk ID of the direct counterparty on the reporting side | relatedBusinessUnit<br>role |
| (d)(3) | the terms of any fixed or floating rate payments, or otherwise customized or non-standard payment streams | genericProduct |
| (d)(3) | the frequency of any fixed or floating rate payments, or otherwise customized or non-standard payment streams | paymentFrequency<br>resetFrequency |
| (d)(3) | the contingencies of any fixed or floating rate payments, or otherwise customized or non-standard payment streams | feature |

| § 901 Ref. | Common Data Model Concept | FpML Data Elements |
|---|---|---|
| (d)(4) | title of any master agreement | masterAgreement<br>masterAgreementId |
| (d)(4) | the date of any master agreement | masterAgreement<br>masterAgreementDate |
| (d)(4) | the title of any collateral agreement | creditSupportAgreement<br>identifier |
| (d)(4) | the date of any collateral agreement | creditSupportAgreement<br>date |
| (d)(4) | the title of any margin agreement | |
| (d)(4) | the date of any margin agreement | |
| (d)(4) | the title of any other agreement | contractualTermsSupplement, et al.<br>identifier |
| (d)(4) | the date of any other agreement | contractualTermsSupplement, et al.<br>date |
| (d)(5) | any additional data elements included in the agreement between the counterparties that are necessary for a person to determine the market value of the transaction; | |
| (d)(6) | the name of the clearing agency to which the security-based swap will be submitted for clearing | partyId<br>partyRole |
| (d)(7) | whether they have invoked the exception in Section 3C(g) of the Exchange Act (15 U.S.C. 78c-3(g)); | endUserException |
| (d)(8) | a description of the settlement terms | cashSettlementTerms |
| (d)(8) | whether the security-based swap is cash-settled or physically settled | physicalSettlementTerms |
| (d)(8) | the method for determining the settlement value | valuationMethod |
| (d)(9) | The platform ID, if applicable | partyId<br>partyRole |
| (d)(10) | the transaction ID of an allocated security-based swap | originatingEvent<br>originatingTradeId<br>allocationTradeId |
| (d)(10) | the transaction ID of a terminated security-based swap | terminatingEvent<br>originatingTradeId |
| (d)(10) | the transaction ID of a novated security-based swap | novation<br>originatingTradeId |
| (d)(10) | the transaction ID of an assigned security-based swap | novation<br>originatingTradeId |

| § 901 Ref. | Common Data Model Concept | FpML Data Elements |
|---|---|---|
| (e)(1)(i) | A life cycle event, and any adjustment due to a life cycle event, that results in a change to information previously reported pursuant to paragraph (c), (d), or (i) of this section shall be reported by the reporting side [except that the reporting side shall not report whether or not a security-based swap has been accepted for clearing] | originatingEvent |
| | | trade |
| (e)(1)(ii) | Acceptance for clearing | |
| (e)(2) | All reports of life cycle events and adjustments due to life cycle events shall, within the timeframe specified in paragraph (j) of this section, be reported to the entity to which the original security-based swap transaction will be reported or has been reported and shall include the transaction ID of the original transaction. | originatingTradeId |
| (f) | Time stamp, to the second, its receipt of any information submitted to it pursuant to paragraph (c), (d), (e), or (i) of this section. | timestamps |
| | | nonpubliclyReported |
| (g) | A transaction ID to each security-based swap, or establish or endorse a methodology for transaction IDs to be assigned by third parties. | originatingTradeId |

**Table 2: Mapping of common data model data concepts to FIXML data elements. When the FIXML column includes a list of terms, this means that FIXML expresses the concept as a combination of data elements from that list. Blank entries mean that the concept does not presently have an exact equivalent in FIXML.**

| § 901 Ref. | Common Data Model Concept | FIXML Data Elements |
|---|---|---|
| (c)(1) | Product ID | Prod |
| | | SecTyp |
| | | PxDtrmnMeth |
| | | SettlMeth |
| | | SwapClss |
| | | SwapSubClss |
| (c)(1)(i) | Asset Class | CFI |
| (c)(1)(i) | Underlying Reference Asset(s) | Undly |
| (c)(1)(i) | Underlying Reference Issuer(s) | Issr |
| (c)(1)(i) | Underlying Reference Index | NdxSeries |
| (c)(1)(ii) | Effective Date | EfctvDt |
| (c)(1)(iii) | Scheduled Termination Date | TrmntDt |
| (c)(1)(iv) | Terms of any standardized fixed rate payments | PmtStrm |
| | | CalcDts |
| | | Rt |

| § 901 Ref. | Common Data Model Concept | FIXML Data Elements |
|---|---|---|
| | | Amt |
| | | Ccy |
| (c)(1)(iv) | Frequency of any fixed rate payments | PmtDts |
| (c)(1)(iv) | Terms of any standardized floating rate payments | ResetDts |
| (c)(1)(iv) | Frequency of any floating rate payments | PmtDts |
| (c)(1)(v) | Custom Swap Flag | |
| (c)(2) | The date and time, to the second, of execution, expressed using Coordinated Universal Time (UTC); | TrdRegTS |
| | | TS |
| | | Typ |
| | | Src |
| (c)(3) | The price | Px |
| (c)(3) | The currency in which the price is expressed | Ccy |
| (c)(3) | The amount(s) of any up-front payments | UpfrontPx |
| (c)(3) | The currenc(ies) of any up-front payments | |
| (c)(4) | The notional amount(s) | Strm |
| | | Notl |
| (c)(4) | The currenc(ies) in which the notional amount(s) is expressed | Ccy |
| (c)(5) | Inter-Dealer Swap Flag | Pty |
| | | Typ |
| (c)(6) | Intention To Clear Flag | ClrIntn |
| (c)(7) | If applicable, any flags pertaining to the transaction that are specified in the policies and procedures of the registered security-based swap data repository to which the transaction will be reported | |
| (d)(1) | The counterparty ID [on the reporting side] | Pty |
| | | ID |
| | | Src |
| | | R |
| | | R |
| | | Sub |
| | | ID |
| | | Typ |
| (d)(1) | The execution agent ID [on the reporting side], as applicable | R |
| (d)(1) | The counterparty ID [on the non-reporting side] | R |
| (d)(1) | The execution agent ID of each counterparty, as applicable | R |

| § 901 Ref. | Common Data Model Concept | FIXML Data Elements |
|---|---|---|
| (d)(1) | [As applicable] the branch ID of the direct counterparty on the reporting side | R |
| (d)(1) | [As applicable] the broker ID of the direct counterparty on the reporting side | R |
| (d)(1) | [As applicable] the execution agent ID of the direct counterparty on the reporting side | R |
| (d)(2) | [As applicable] the trader ID of the direct counterparty on the reporting side | R |
| (d)(2) | [As applicable] the trading desk ID of the direct counterparty on the reporting side | R |
| (d)(3) | the terms of any fixed or floating rate payments, or otherwise customized or non-standard payment streams | |
| (d)(3) | the frequency of any fixed or floating rate payments, or otherwise customized or non-standard payment streams | PmtDts |
| | | PmtDts |
| (d)(3) | the contingencies of any fixed or floating rate payments, or otherwise customized or non-standard payment streams | ContingencyType |
| (d)(4) | title of any master agreement | FinDetls |
| | | AgmtDesc |
| (d)(4) | date of any master agreement | AgmtDt |
| (d)(4) | title of any collateral agreement | CrdSuprtDesc |
| (d)(4) | date of any collateral agreement | CrdSuprtDt |
| (d)(4) | title of any margin agreement | |
| (d)(4) | date of any margin agreement | |
| (d)(4) | title of any any other agreement | CnfmDesc |
| | | BrkrCnfmDesc |
| (d)(4) | date of any any other agreement | CnfmDt |
| (d)(5) | any additional data elements included in the agreement between the counterparties that are necessary for a person to determine the market value of the transaction | |
| (d)(6) | the name of the clearing agency to which the security-based swap will be submitted for clearing | R |
| | | ID |
| (d)(7) | whether they have invoked the exception in Section 3C(g) of the Exchange Act (15 U.S.C. 78c-3(g)) | ClrReqmtExcptn |
| (d)(8) | a description of the settlement terms | |
| (d)(8) | whether the security-based swap is cash-settled or physically settled | SettlMeth |
| | the method for determining the settlement | SettlNdx |

| § 901 Ref. | Common Data Model Concept | FIXML Data Elements |
|---|---|---|
| | value | SettlNdxLctn |
| (d)(9) | The platform ID, if applicable | R |
| | | ID |
| | | Src |
| (d)(10) | the transaction ID of an allocated security-based swap | AllExc |
| | | TransTyp |
| | | TrdID |
| (d)(10) | the transaction ID of a terminated security-based swap | RegTrdID |
| | | TrmTyp |
| | | TrdID |
| (d)(10) | Novation transaction ID | TrdContntn |
| | | TrdContntn |
| | | OrigTrdID |
| | | Side |
| (d)(10) | the transaction ID of an assigned security-based swap | AsgnTyp |
| | | TrdID |
| (e)(1)(i) | A life cycle event, and any adjustment due to a life cycle event, that results in a change to information previously reported pursuant to paragraph (c), (d), or (i) of this section shall be reported by the reporting side [except that the reporting side shall not report whether or not a security-based swap has been accepted for clearing] | TrdContntn |
| | | TrdContntn |
| (e)(1)(ii) | Acceptance for clearing | RskLmitChkStat |
| (e)(2) | All reports of life cycle events and adjustments due to life cycle events shall, within the timeframe specified in paragraph (j) of this section, be reported to the entity to which the original security-based swap transaction will be reported or has been reported and shall include the transaction ID of the original transaction. | OrigTrdID |
| (f) | Time stamp, to the second, its receipt of any information submitted to it pursuant to paragraph (c), (d), (e), or (i) of this section. | TrdRegTS |
| | | TS |
| | | Typ |
| | | Src |
| (g) | A transaction ID to each security-based swap, or establish or endorse a methodology for transaction IDs to be assigned by third parties. | TrdID |

Piwowar Disapproved

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Parts 270 and 274**

**Release No. IC-31933; File No. S7-24-15**

**RIN: 3235-AL60**

# Use of Derivatives by Registered Investment Companies and Business Development Companies

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission (the "Commission" or "SEC") is proposing rule 18f-4, a new exemptive rule under the Investment Company Act of 1940 (the "Investment Company Act" or "Act") designed to address the investor protection purposes and concerns underlying section 18 of the Act and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives. The proposed rule would permit mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and companies that have elected to be treated as business development companies ("BDCs") under the Act (collectively, "funds") to enter into derivatives transactions and financial commitment transactions (as those terms are defined in the proposed rule) notwithstanding the prohibitions and restrictions on the issuance of senior securities under section 18 of the Act, provided that the funds comply with the conditions of the proposed rule. A fund that relies on the proposed rule in order to enter into derivatives transactions would be required to: comply with one of two alternative portfolio limitations designed to impose a limit on the amount of leverage the fund may obtain through derivatives transactions and other senior securities transactions; manage the risks associated with the fund's derivatives transactions by maintaining an amount of certain assets, defined in the rule as "qualifying coverage assets," designed to enable the fund to meet its obligations under its

derivatives transactions; and, depending on the extent of its derivatives usage, establish a formalized derivatives risk management program. A fund that relies on the proposed rule in order to enter into financial commitment transactions would be required to maintain qualifying coverage assets equal in value to the fund's full obligations under those transactions. The Commission also is proposing amendments to proposed Form N-PORT and proposed Form N-CEN that would require reporting and disclosure of certain information regarding a fund's derivatives usage.

**DATES:** Comments should be received on or before ____ [insert date approximately 90 days after publication in the Federal Register].

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

Electronic Comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/concept.shtml);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-24-15 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 to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-24-15. 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/proposed.shtml).

Comments also are available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

Studies, memoranda or other substantive items may be added by the Commission or staff to the comment file during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Commission's website. To ensure direct electronic receipt of such notifications, sign up through the "Stay Connected" option at www.sec.gov to receive notifications by e-mail.

**FOR FURTHER INFORMATION CONTACT:** With respect to proposed rule 18f-4, Adam Bolter, Jamie Lynn Walter, or Erin C. Loomis, Senior Counsels; Thoreau A. Bartmann, Branch Chief; Brian McLaughlin Johnson, Senior Special Counsel; or Aaron Schlaphoff or Danforth Townley, Attorney Fellows; and with respect to the proposed amendments to Form N-PORT and Form N-CEN, Jacob D. Krawitz, Senior Counsel, or Sara Cortes, Senior Special Counsel, at (202)-551-6792, Investment Company Rulemaking Office, Division of Investment Management, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-8549.

**SUPPLEMENTARY INFORMATION:** The Commission is proposing rule 18f-4 [17 CFR 270.18f-4] under the Investment Company Act of 1940 [15 U.S.C. 80a] and amendments to proposed Form N-PORT and proposed Form N-CEN.

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## I. INTRODUCTION

The activities and capital structures of funds are regulated extensively under the Investment Company Act,[1] Commission rules, and Commission guidance.[2] The use of

[1] 15 U.S.C. 80a. Unless otherwise noted, all references to statutory sections are to the Investment

derivatives by funds implicates certain requirements under the Investment Company Act, including section 18 of that Act. As discussed in more detail below, section 18 limits a fund's ability to obtain leverage or incur obligations to persons other than the fund's common shareholders through the issuance of senior securities, as defined in that section.

Derivatives may be broadly described as instruments or contracts whose value is based upon, or derived from, some other asset or metric (referred to as the "reference asset," "underlying asset" or "underlier").[3] Funds employ derivatives for a variety of purposes, including to: seek higher returns through increased investment exposures; hedge interest rate, credit, and other risks in their investment portfolios; gain access to certain markets; and achieve greater transaction efficiency.[4] At the same time, derivatives can raise risks for a fund relating to, for example, leverage, illiquidity (particularly with respect to complex over-the-counter ("OTC") derivatives), counterparties, and the ability of the fund to meet its obligations.[5]

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Company Act, and all references to rules under the Investment Company Act, including proposed rule 18f-4, will be to Title 17, Part 270 of the Code of Federal Regulations, 17 CFR Part 270.

2 Our staff has also issued no-action and other letters that relate to fund use of derivatives. In addition to Investment Company Act provisions, funds using derivatives (and financial commitment transactions) must comply with all other applicable statutory and regulatory requirements, such as other federal securities law provisions, the Internal Revenue Code (the "IRC"), Regulation T of the Federal Reserve Board ("Regulation T"), and the rules and regulations of the Commodity Futures Trading Commission (the "CFTC"). *See also* Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank Act"), *available at* http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf.

3 *See* Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (Aug. 31, 2011) [76 FR 55237 (Sept. 7, 2011)] ("Concept Release"), at n.3.

4 *See* Concept Release, *supra* note 3, at n.5.

5 *See* Concept Release, *supra* note 3, at n.6. As discussed in Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Release No. 31835 (Sept. 22, 2015) [80 FR 62273(Oct. 15, 2015)] ("Liquidity Release"), long-standing Commission guidelines generally limit an open-end fund's aggregate holdings of "illiquid" assets to 15% of

We are committed, as the primary regulator of funds, to designing regulatory programs that respond to the risks associated with the increasingly complex portfolio composition and operations of the asset management industry. The dramatic growth in the volume and complexity of the derivatives markets over the past two decades, and the increased use of derivatives by certain funds,[6] led us to initiate a review of funds' use of derivatives under the Investment Company Act to evaluate whether the regulatory framework, as it applied to funds' use of derivatives, continues to fulfill the purposes and policies underlying the Act and is consistent with investor protection. We published a Concept Release on funds' use of derivatives in 2011 (the "Concept Release") to assist with this review and solicit public comment on the current regulatory framework.[7] As noted in the Concept Release, our staff has been exploring the benefits, risks, and costs associated with funds' use of derivatives. Our staff's review of these and other matters, together with input from commenters on the Concept Release and others, have informed our consideration of the regulation of funds' use of derivatives, including in particular whether funds' current practices, based on their application of Commission and staff guidance, are consistent with the investor protection purposes and concerns underlying section 18 of the Investment Company Act.

Today, we are proposing new rule 18f-4, which is designed to address the investor protection purposes and concerns underlying section 18 and to provide an updated and more

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the fund's net assets. Under these guidelines, an asset is considered illiquid if it cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment. These guidelines apply to all investments (including derivatives) held by an open-end fund. Proposed rule 22e-4, which we proposed in September 2015, would codify this standard along with other requirements that are designed to promote effective liquidity risk management for open-end funds.

6 *See* Concept Release, *supra* note 3, at n.7. *See also infra* section II.

7 *See* Concept Release, *supra* note 3.

comprehensive approach to the regulation of funds' use of derivatives transactions and other transactions that implicate section 18 in light of the dramatic growth in the volume and complexity of the derivatives markets over the past two decades and the increased use of derivatives by certain funds. As discussed in more detail below, the new rule would permit a fund to enter into derivatives and financial commitment transactions, notwithstanding the prohibitions and restrictions on the issuance of senior securities under section 18 of the Act, provided that the fund complies with the conditions of the proposed rule. The proposed rule's conditions are designed both to impose a limit on the leverage a fund may obtain through the use of derivatives and financial commitment transactions and other senior securities transactions, and to require the fund to have assets available to meet its obligations arising from those transactions, both of which are central investor protection purposes and concerns underlying section 18. The proposed rule also would require funds that engage in more than a limited amount of derivatives transactions or that use certain complex derivatives transactions, as defined in the rule, to establish formalized risk management programs to manage the risks associated with such transactions.

## II. BACKGROUND

### A. Background Concerning the Use of Derivatives by Funds

As noted above, derivatives may be broadly described as instruments or contracts whose value is based upon, or derived from, some reference asset. Reference assets can include, for example, stocks, bonds, commodities, currencies, interest rates, market indices, currency exchange rates, or other assets or interests.[8] Common examples of derivatives used by funds

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8 For example, the reference asset of a Standard & Poor's ("S&P") 500 futures contract is the S&P 500 index.

include forwards, futures, swaps, and options.[9]

Derivatives are often characterized as either exchange-traded or OTC.[10] Exchange-traded derivatives—such as futures,[11] certain options,[12] and options on futures[13]—are standardized contracts traded on regulated exchanges, such as the Chicago Mercantile Exchange and the Chicago Board Options Exchange. OTC derivatives—such as certain swaps,[14] non-exchange

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9 *See, e.g.*, Concept Release, *supra* note 3, at nn.35-46 and accompanying text.

10 *See* Concept Release, *supra* note 3, at n.22.

11 A futures contract is a standardized contract between two parties to buy or sell a specified asset of standardized quantity and quality, for an agreed upon price (the "futures price" or "strike price"), with delivery and payment occurring at a specified future date (the "delivery date"). The contracts are negotiated on a futures exchange which acts as an intermediary between the two parties. The party agreeing to buy the underlying asset in the future, the "buyer" of the contract, is said to be "long," and the party agreeing to sell the asset in the future, the "seller" of the contract, is said to be "short." The long position (buyer) hopes or expects that the asset price is going to increase, while the short position (seller) hopes or expects that it will decrease. For a general discussion of futures contracts, *see, e.g.*, John C. Hull, OPTIONS, FUTURES, AND OTHER DERIVATIVES (9th ed. 2015), at 24.

12 An option is the right to buy or sell an asset. There are two basic types of options, a "call option" and a "put option." A call option gives the holder the right (but does not impose the obligation) to buy the underlying asset by or at a certain date for a certain price. The seller, or "writer," of a call option has the obligation to sell the underlying asset to the holder if the holder exercises the option. A put option gives the holder the right (but does not impose the obligation) to sell the underlying asset by or at a certain date for a certain price. The seller, or "writer," of a put option has the obligation to buy from the holder the underlying asset if the holder exercises the option. The price that the option holder must pay to exercise the option is known as the "exercise" or "strike" price. The amount that the option holder pays to purchase an option is known as the "option premium," "price," "cost," or "fair value" of the option. *See* Concept Release, *supra* note 3, at n.23.

13 Options on futures generally trade on the same exchange as the relevant futures contract. When a call option on a futures contract is exercised, the holder acquires from the writer a long position in the underlying futures contract plus a cash amount equal to the excess of the futures price over the strike price. When a put option on a futures contract is exercised, the holder acquires a short position in the underlying futures contract plus a cash amount equal to the excess of the strike price over the futures price. *See* Concept Release, *supra* note 3, at n.24.

14 A "swap" is generally an agreement between two counterparties to exchange periodic payments based upon the value or level of one or more rates, indices, assets, or interests of any kind. For example, counterparties may agree to exchange payments based on different currencies or interest rates. *See* Concept Release, *supra* note 3, at n.25. Except as otherwise specified or the context otherwise requires, we use the term "swap" in this Release to refer collectively to swaps, as defined in section 1a of the Commodity Exchange Act, 7 U.S.C. 1a (the "CEA"), and security-

traded options, and combination products such as swaptions[15] and forward swaps[16]—are contracts negotiated and entered into outside of an organized exchange. Unlike exchange-traded derivatives, OTC derivatives may be significantly customized, and may not be cleared by a central clearing organization. OTC derivatives that are not centrally cleared may involve greater counterparty credit risk, and may be more difficult to value, transfer, or liquidate than exchange-traded derivatives.[17] The Dodd-Frank Act and rules thereunder seek to establish a comprehensive new regulatory framework for two broad categories of derivatives—swaps and security-based swaps. The framework is designed to reduce risk, increase transparency, and promote market integrity within the financial system.[18]

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based swaps, as defined in section 3(a)(68) of the Exchange Act.

15 A "swaption" is an option to enter into an interest rate swap where a specified fixed rate is exchanged for a floating rate. *See* Concept Release, *supra* note 3, at n.26.

16 A forward swap (or deferred swap) is an agreement to enter into a swap at some time in the future ("deferred swap"). *See* Concept Release, *supra* note 3, at n.27.

17 An OTC derivative may be more difficult to transfer or liquidate than an exchange-traded derivative because, for example, an OTC derivative may provide contractually for non-transferability without the consent of the counterparty, or may be sufficiently customized that its value is difficult to establish or its terms too narrowly drawn to attract transferees willing to accept assignment of the contract, unlike most exchange-traded derivatives. *See* Concept Release, *supra* note 3, at n.28.

18 The Dodd-Frank Act, *supra* note 2, was signed into law on July 21, 2010. The Act mandates, among other things, substantial changes in the OTC derivatives markets, including new clearing, reporting, and trade execution mandates for swaps and security-based swaps, and both exchange-traded and OTC derivatives are contemplated under the new regime. *See* Dodd-Frank Act sections 723 (mandating clearing of swaps) and 763 (mandating clearing of security-based swaps). We have noted that these Dodd-Frank Act requirements "were designed to provide greater certainty that, wherever possible and appropriate, swap and security-based swap contracts formerly traded exclusively in the OTC market are centrally cleared." Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, Securities Exchange Act Release No. 67286 (June 28, 2012) [77 FR 41602 (July 13, 2012)], at text accompanying n.5.

While funds use derivatives for a variety of purposes, a common characteristic of most derivatives is that they involve leverage or the potential for leverage.[19] We have stated that "[l]everage exists when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return."[20] Many derivatives transactions entered into by a fund, such as futures contracts, swaps, and written options, involve leverage or the potential for leverage in that they enable the fund to participate in gains and losses on an amount of reference assets that exceeds the fund's investment, while also imposing a conditional or unconditional obligation on the fund to make a payment or deliver assets to a counterparty.[21] Other derivatives transactions, such as purchased call options, provide the economic equivalent of leverage because they expose the fund to gains on an amount in excess of the fund's investment but do not impose a payment obligation on the fund beyond its investment.[22]

Funds use derivatives both to obtain investment exposures as part of their investment strategies and to manage risk.[23] A fund may use derivatives to gain, maintain, or reduce

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19 *See*, *e.g.*, *infra* notes 69-71.

20 *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979) [44 FR 25128 (Apr. 27, 1979)] ("Release 10666"), at n.5. *See also infra* notes 21-22.

21 The leverage created by such an arrangement is sometimes referred to as "indebtedness leverage." *See* Concept Release, *supra* note 3, at n.31. *See infra* notes 70-72 and accompanying text.

22 This type of leverage is sometimes referred to as "economic leverage." *See* Concept Release, *supra* note 3, at n.32.

23 *See* Concept Release, *supra* note 3, at n.33. A fund may also use derivatives to hedge current portfolio exposures (for example, when a fund's portfolio is structured to reflect the fund's long-term investment strategy and its investment adviser's forecasts, interim events may cause the fund's investment adviser to seek to temporarily hedge a portion of the portfolio's broad market, sector, and/or security exposures). Industry participants believe that derivatives may also provide a more efficient hedging tool than reducing exposure by selling individual securities, offering greater liquidity, lower round-trip transaction costs, lower taxes, and reduced disruption to the portfolio's longer-term positioning. *Id.* *See also infra* note 25 and accompanying text.

exposure to a market, sector, or security more quickly and/or with lower transaction costs and portfolio disruption than investing directly in the underlying securities.[24] The comments we received on the Concept Release reflect some of the various ways in which funds use derivatives, including, for example: to hedge risks associated with the fund's securities investments; to equitize cash to gain exposure quickly, such as by purchasing index futures rather than investing in the securities underlying the index; and to obtain synthetic positions.[25]

At the same time and as noted above, funds' use of derivatives may entail risks relating to, for example, leverage, illiquidity (particularly with respect to complex OTC derivatives), and counterparty risk, among others.[26] A fund's use of derivatives presents challenges for its investment adviser and board of directors in managing derivatives use so that they are employed in a manner consistent with the fund's investment objectives, policies, and restrictions, its risk profile, and relevant regulatory requirements, including those under the federal securities laws.[27]

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24 *See* Concept Release, *supra* note 3, at section I.

25 *See*, *e.g.*, Comment Letter of BlackRock on Concept Release (Nov. 4, 2011) (File No. S7-33-11) ("BlackRock Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-39.pdf; Comment Letter of AQR Capital Management on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("AQR Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-26.pdf; Comment Letter of Vanguard on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("Vanguard Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-38.pdf; Comment Letter of Oppenheimer Funds on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("Oppenheimer Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-44.pdf; Comment Letter of Loomis, Sayles and Company on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("Loomis Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-25.pdf; Comment Letter of Investment Company Institute on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("ICI Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-46.pdf.

26 *See* Concept Release, *supra* note 3, at n.34.

27 *See*, *e.g.*, Comment Letter of Mutual Fund Directors Forum on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("MFDF Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-32.pdf, at 2 (agreeing with this statement in the Concept Release and suggesting that we "evaluate how any potential regulations will impact the ability of directors effectively to oversee their funds' use of derivatives").

## B. Derivatives and the Senior Securities Restrictions of the Investment Company Act

### *1. Requirements of Section 18*

Section 18 of the Act imposes various limitations on the capital structure of funds, including, in part, by restricting the ability of funds to issue "senior securities." The protection of investors against the potentially adverse effects of a fund's issuance of senior securities is a core purpose of the Investment Company Act.[28] Section 18(g) of the Investment Company Act defines "senior security," in part, as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness."[29]

Congress' concerns underlying the limitations in section 18 were focused on: (i) excessive borrowing and the issuance of excessive amounts of senior securities by funds which increased unduly the speculative character of their junior securities;[30] (ii) funds operating without adequate assets and reserves;[31] and (iii) potential abuse of the purchasers of senior securities.[32] To address these concerns, section 18(f)(1) of the Investment Company Act prohibits an open-end fund[33] from issuing or selling any "senior security" other than borrowing from a bank and

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28 *See, e.g.*, sections 1(b)(7), 1(b)(8), 18(a), and 18(f) of the Investment Company Act.

29 The definition of senior security in section 18(g) also includes "any stock of a class having priority over any other class as to the distribution of assets or payment of dividends" and excludes certain limited temporary borrowings.

30 *See* section 1(b)(7) of the Investment Company Act; Release 10666, *supra* note 20, at n.8.

31 *See* section 1(b)(8) of the Investment Company Act; Release 10666, *supra* note 20, at n.8.

32 *See* Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 1 (1940) ("Senate Hearings") at 265-78. *See also Mutual Funds and Derivative Instruments*, Division of Investment Management Memorandum transmitted by Chairman Levitt to Representatives Markey and Fields (Sept. 26, 1994) ("1994 Report"), *available at* http://www.sec.gov/news/studies/deriv.txt, at 21 (describing the practices in the 1920s and 1930s that gave rise to section 18's limitations on leverage).

33 Section 5(a)(1) of the Investment Company Act defines "open-end company" as "a management company which is offering for sale or has outstanding any redeemable security of which it is the

subject to a requirement to maintain 300% "asset coverage."[34] Section 18(a)(1) of the Investment Company Act similarly prohibits a closed-end fund[35] from issuing or selling any "senior security that represents an indebtedness" unless it has at least 300% "asset coverage, " although closed-end funds' ability to issue senior securities representing indebtedness is not limited to bank borrowings, and closed-end funds also may issue senior securities that are a stock, subject to limitations in section 18.[36] A BDC is also subject to the limitations of section 18(a)(1)(A) to the same extent as if it were a closed-end investment company except that the applicable asset coverage amount for any senior security representing indebtedness is 200%.[37]

### 2. *Investment Company Act Release 10666*

In Investment Company Act Release 10666, issued in 1979, we considered the application of section 18's restrictions on senior securities to the following transactions: reverse repurchase agreements, firm commitment agreements, and standby commitment agreements.[38] As we described in more detail in Release 10666, in a reverse repurchase agreement, a fund transfers possession of a security to another party in return for a percentage of the value of the

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issuer."

34 "Asset coverage" of a class of securities representing indebtedness of an issuer generally is defined in section 18(h) of the Investment Company Act as "the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer." Take, for example, an open-end fund with $100 in assets and with no liabilities or senior securities outstanding. The fund could, while maintaining the required coverage of 300% of the value of its assets subject to section 18 of the Act, borrow an additional $50 from a bank; the $50 in borrowings would represent one-third of the fund's $150 in total assets, measured after the borrowing (or 50% of the fund's $100 net assets).

35 Section 5(a)(2) of the Investment Company Act defines "closed-end company" as "any management company other than an open-end company."

36 Section 18(a)(1)(A).

37 *See* section 61(a)(1) of the Investment Company Act. BDCs, like registered closed-end funds, also may issue a senior security that is a stock (*e.g.*, preferred stock), subject to limitations in section 18. *See* section 18(a)(2) and section 61(a)(1) of the Investment Company Act.

38 *See* Release 10666, *supra* note 20.

security; at an agreed upon future date, the fund repurchases the transferred security by paying an amount equal to the proceeds of the transaction plus interest.[39] A firm commitment agreement is a buy order for delayed delivery under which a fund agrees to purchase a security—a Ginnie Mae, in the example we provided in Release 10666[40]—from a seller at a future date, stated price, and fixed yield; a standby commitment agreement similarly involves an agreement by the fund to purchase a security with a stated price and fixed yield in the future upon the counterparty's exercise of its option to sell the security to the fund.[41]

We concluded that such agreements, while not securities for all purposes under the federal securities laws,[42] "fall within the functional meaning of the term 'evidence of indebtedness' for purposes of section 18 of the Act," which we noted would generally include "all contractual obligations to pay in the future for consideration presently received," and thus may involve the issuance of senior securities.[43] Further, we stated that "trading practices

39 *See* Release 10666, *supra* note 20, at discussion of "Reverse Repurchase Agreements" (noting that a reverse repurchase agreement may not have an agreed upon repurchase date, and in that case, the agreement would be treated as if it were reestablished each day).

40 In Release 10666, we described reverse repurchase agreements and firm and standby commitment agreements involving debt securities guaranteed as to principal and interest by the Government National Mortgage Associations, or "Ginnie Maes." We noted, however, that we referenced Ginnie Maes only as an example of the underlying security and the reference should not be construed as delimiting our general statement of policy; we further noted that we sought in Release 10666 to "address generally the possible economic effects and legal implications of all comparable trading practices which may affect the capital structure of investment companies in a manner analogous to the securities trading practices specifically discussed [in Release 10666]." *Id.*, at discussion of "Areas of Concern." *See also infra* section III.A.2.

41 *See* Release 10666, *supra* note 20, at discussion of "Firm Commitment Agreements," and "Standby Commitment Agreements."

42 *See* Release 10666, *supra* note 20, at "The Agreements as Securities" discussion. *See also infra* note 61.

43 Release 10666, *supra* note 20, at "The Agreements as Securities" discussion.

involving the use by investment companies of such agreements for speculative purposes or to accomplish leveraging fall within the legislative purposes of section 18."[44]

We recognized, however, that although reverse repurchase agreements, firm commitment agreements, and standby commitment agreements may involve the issuance of senior securities and thus generally would be prohibited for open-end funds by section 18(f) (and limited by the 300% asset coverage requirement for closed-end funds), these and similar arrangements nonetheless could appropriately be used by funds subject to the constraints we described in Release 10666. We analogized to short sales of securities by funds, as to which our staff had previously provided guidance that the issue of section 18 compliance would not be raised if funds "cover" senior securities by maintaining "segregated accounts."[45]

We concluded that the use of segregated accounts "if properly created and maintained, would limit the investment company's risk of loss."[46] To avail itself of the segregated account approach, we stated that a fund could establish and maintain with the fund's custodian a segregated account containing certain liquid assets, such as cash, U.S. government securities, or other appropriate high-grade debt obligations, equal to the obligation incurred by the fund in connection with the senior security ("segregated account approach").[47] We stated that the

44 *Id.* (stating, among other things, that, "[t]he gains and losses from the transactions can be extremely large relative to invested capital; for this reason, each agreement has speculative aspects. Therefore, it would appear that the independent investment decisions involved in entering into such agreements, which focus on their distinct risk/return characteristics, indicate that, economically as well as legally, the agreements should be treated as securities separate from the underlying Ginnie Maes for purposes of section 18 of the Act.")

45 *See* Release 10666, *supra* note 20, at text accompanying n.15 (citing Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972) at 6-8).

46 *See* Release 10666, *supra* note 20, at discussion of "Segregated Account."

47 We stated that, under the segregated account approach, the value of the assets in the segregated account should be marked to the market daily, additional assets should be placed in the segregated account whenever the total value of the account falls below the amount of the fund's

segregated account functions as "a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock," and that it "[would] assure the availability of adequate funds to meet the obligations arising from such activities."[48]

We did not specifically address derivatives in Release 10666.[49] We did, however, state that although we were expressing our views about the particular trading practices discussed in that release, our views were not limited to those trading practices, in that we sought to "address generally the possible economic effects and legal implications of all comparable trading practices

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obligation, and assets in the segregated account should be deemed frozen and unavailable for sale or other disposition. *See id.* We also cautioned that as the percentage of a fund's portfolio assets that are segregated increases, the fund's ability to meet current obligations, to honor requests for redemption, and to manage properly the investment portfolio in a manner consistent with its stated investment objective may become impaired. *Id.* We stated that the amount of assets to be segregated with respect to reverse repurchase agreements lacking a specified repurchase price would be the value of the proceeds received plus accrued interest; for reverse repurchase agreements with a specified repurchase price, the amount of assets to be segregated would be the repurchase price; and for firm and standby commitment agreements, the amount of assets to be segregated would be the purchase price. *Id.*

48 *Id.*

49 The derivatives markets have expanded substantially since we issued Release 10666 in 1979. For example, the Options Clearing Corporation reports that in 1979, only 64 million contracts were traded on 220 equity issues. By 2014, those numbers had risen to 3,845 million contracts traded on 4,278 equity issues. The CME Group reports that 313 of its 335 derivatives products began trading after 1979 (*see* http://www.cmegroup.com/company/history/cmegroupinformation.html). For example, the Chicago Mercantile Exchange launched its first cash-settled futures contract in 1981 and its first successful stock index future (S&P 500 index) in 1982 (*see* http://www.cmegroup.com/company/history/timeline-of-achievements.html). *See also* Jennifer Lynch Koski & Jeffrey Pontiff, *How Are Derivatives Used? Evidence from the Mutual Fund Industry*, 54 THE J. OF FIN. 791, 792 (Apr. 1999), *available at* http://onlinelibrary.wiley.com/doi/10.1111/0022-1082.00126/pdf (observing that the Taxpayer Relief Act of 1997's repeal of the "short-short rule" would likely lead to increased derivative use by mutual funds because that rule "eliminate[d] preferential pass-through tax status for funds that realize more than 30 percent of their capital gains from positions held less than three months" and "inhibited derivative use because some derivative securities such as options and futures contracts involve realizing capital gains for holding periods of less than three months").

which may affect the capital structure of investment companies in a manner analogous to the securities trading practices specifically discussed in Release 10666."[50]

### *3. Developments after Investment Company Act Release No. 10666*

In the years following the issuance of Release 10666, our staff issued more than thirty no-action letters to funds concerning the maintenance of segregated accounts or otherwise "covering" their obligations in connection with various transactions that implicate section 18.[51] In these letters and through other staff guidance, our staff has addressed questions as they were presented to the staff, generally on an instrument-by-instrument basis, regarding the application of our statements in Release 10666 to various types of derivatives and other transactions. As derivatives markets expanded and funds increased their use of derivatives,[52] industry practices have developed over time, based at least in part on our staff's no-action letters and other staff guidance, concerning the appropriate amount and type of assets that should be segregated in order to "cover" various types of derivatives transactions.[53]

With respect to the amount of assets that funds have segregated, two general practices have developed:

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50 Release 10666, *supra* note 20, at "Areas of Concern" and "Background" discussion.

51 The Concept Release includes a discussion of certain staff no-action letters. *See* Concept Release, *supra* note 3, at section I.

52 *See, e.g.*, Comment Letter of Davis Polk & Wardwell LLP on Concept Release (Nov. 11, 2011) (File No. S7-33-11) ("Davis Polk Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-49.pdf ("[T]he Commission and the Staff, over the years, have addressed issues pertaining to the use of derivatives transactions by registered funds on an intermittent case-by-case basis. While this guidance has been helpful, it has not been able to keep pace with the dramatic expansion of the derivatives market over the past twenty years, both in terms of the types of instruments that are available and the extent to which funds use them.").

53 Our staff also has stated that it would not object to a fund covering its obligations by entering into certain cover transactions or holding the asset (or the right to acquire the asset) that the fund would be required to deliver under certain derivatives. *See* Concept Release, *supra* note 3, at text following nn.70-71.

- For some derivatives, funds generally segregate an amount equal to the full amount of the fund's potential obligation under the contract, where that amount is known at the outset of the transaction, or the full market value of the underlying reference asset for the derivative (collectively, "notional amount segregation").[54] Funds have applied this approach to, among other transactions, futures, forward contracts and written options that permit physical settlement, and credit default swaps ("CDS") regardless of whether physical settlement or cash settlement is contemplated.[55]

- For certain derivatives that are required by their terms to be net cash settled, and thus do not involve physical settlement, funds often segregate an amount equal to the fund's

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54 *See, e.g.*, Concept Release, *supra* note 3, at n.78 and accompanying text (explaining that, "[i]n determining the amount of assets required to be segregated to cover a particular instrument, the Commission and its staff have generally looked to the purchase or exercise price of the contract (less margin on deposit) for long positions and the market value of the security or other asset underlying the agreement for short positions, measured by the full amount of the reference asset, *i.e.*, the notional amount of the transaction rather than the unrealized gain or loss on the transaction, *i.e.*, its current mark-to-market value"). *See also, e.g.*, Davis Polk Concept Release Comment Letter, at 3 ("In Release 10666 and in no-action letters, the Commission and the Staff generally indicated that funds relying on the segregation method should segregate assets equal to the full notional value of the reference asset for a derivative (the 'notional amount'), less any collateral or margin on deposit.").

55 For example, if a fund enters into a long, physically settled forward contract, and the contract specifies the forward price that the fund will pay at settlement, the fund would, consistent with staff positions, segregate this forward/contract price. *See, e.g.*, Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC Staff No-Action Letter (June 22, 1987) ("Dreyfus No-Action Letter"), *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/dreyfusstrategic033087.pdf. As another example, if a fund enters into a short, physically settled forward and the contract obligates the fund to deliver a specific quantity of an asset at settlement—but the total value of that deliverable obligation is unknown at the contract's outset—the fund would, consistent with staff positions, segregate, on a daily basis, liquid assets with a value equal to the daily market value of the deliverable. *See id.*; Robertson Stephens Investment Trust, SEC Staff No-Action Letter (Aug. 24, 1995) ("Robertson Stephens No-Action Letter"), *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/robertsonstephens040395.pdf. *See also supra* note 47.

daily mark-to-market liability, if any ("mark-to-market segregation").[56] Funds initially applied this approach to specific types of transactions addressed through guidance by our staff: first interest rate swaps and later cash-settled futures and non-deliverable forwards ("NDFs").[57] We understand, however, that many funds now apply mark-to-market segregation to a wider range of cash-settled instruments.[58] Our staff has observed that some funds appear to apply the mark-to-market approach to any derivative that is cash settled.

As noted above, in Release 10666, we stated that the assets eligible to be included in segregated accounts should be "liquid assets," such as cash, U.S. government securities, or other appropriate high-grade debt obligations. In a 1996 staff no-action letter, the staff took the position that a fund could cover its senior securities-related obligations by depositing any liquid asset, including equity securities and non-investment grade debt securities, in a segregated account.[59] With respect to the manner in which segregation may be effected, the staff took the

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56 *See*, *e.g*., Concept Release, *supra* note 3, at nn.75-77 and accompanying text (explaining that "[c]ertain swaps, for example, that settle in cash on a net basis, appear to be treated by many funds as requiring segregation of an amount of assets equal to the fund's daily mark-to-market liability, if any").

57 Our staff provided this guidance in the context of its review of certain funds' registration statements.

58 *See*, *e.g*., Comment Letter of Ropes & Gray LLP on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("Ropes & Gray Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-21.pdf, at 4 ("It now appears to be an increasingly common practice for funds that engage in cash-settled swaps to segregate assets only to the extent required to meet the fund's daily mark-to-market liability, if any, relating to such swaps."); Davis Polk Concept Release Comment Letter, at 3 ("[F]und registration statements indicate that, in recent years, the Staff has not objected to the adoption by funds of policies that require segregation of the mark-to-market value, rather than the notional amount, for a variety of swaps as well as for cash-settled futures and forward contracts.").

59 *See* Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996) ("Merrill Lynch No-Action letter"), *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/merrilllynch070196.pdf.

position that a fund could segregate assets by designating such assets on its books, rather than establishing a segregated account at its custodian.[60]

As this discussion reflects, funds and their counsel, in light of the guidance we provided in Release 10666 and that provided by our staff through no-action letters and otherwise, have applied the segregated account approach to, or otherwise sought to cover, many types of transactions other than those specifically addressed in Release 10666, including various derivatives and other transactions that implicate section 18. These transactions include, for example, futures, written options, and swaps (both swaps and security-based swaps).

#### 4. *Current Views Concerning Section 18*

As we stated in Release 10666, we view the transactions described in that release as falling within the functional meaning of the term "evidence of indebtedness," for purposes of section 18.[61] The trading practices described in Release 10666, as well as short sales of securities for which the staff initially developed the segregated account approach we applied in Release 10666, all impose on a fund a conditional or unconditional contractual obligation to pay or deliver assets in the future to a counterparty and thus involve the issuance of a senior security for purposes of section 18.[62]

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60 *See* Dear Chief Financial Officer Letter from Lawrence A. Friend, Chief Accountant, Division of Investment Management (Nov. 7, 1997), *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/imcfo120797.pdf.

61 *See* Release 10666, *supra* note 20, at "The Agreements as Securities" discussion. In addition, as we noted in the Concept Release, the Investment Company Act's definition of the term "security" is broader than the term's definition in other federal securities laws. *Compare* section 2(a)(36) of the Investment Company Act with sections 2(a)(1) and 2A of the Securities Act of 1933 ("Securities Act") and sections 3(a)(10) and 3A of the Exchange Act. *See also* Concept Release, *supra* note 3, at n.57 and accompanying text (explaining that we have interpreted the term "security" in light of the policies and purposes underlying the Investment Company Act).

62 *See* Release 10666, *supra* note 20, at "The Agreements as Securities" discussion. *See also* section 18(g) (defining the term "senior security," in part, as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness"). Under the

We apply the same analysis to derivatives transactions under which the fund is or may be required to make any payment or deliver cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise (a "future payment obligation"). As was the case with respect to the trading practices we described in Release 10666, where the fund has entered into a derivatives transaction and has a future payment obligation—a conditional or unconditional contractual obligation to pay in the future[63]—we believe that such a transaction involves an evidence of indebtedness that is a senior security for purposes of section 18.[64]

This interpretation is supported by the express scope of section 18, which defines the term senior security broadly to include instruments and transactions that might not otherwise be

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proposal, a fund would be permitted to enter into reverse repurchase agreements, short sale borrowings, or any firm or standby commitment agreement or similar agreement (collectively, "financial commitment transactions"), notwithstanding the prohibitions and restrictions on the issuance of senior securities under section 18, provided the fund complies with the proposed rule's conditions. *See infra* section III.A.

63 Unless otherwise specified or the context otherwise requires, the term "derivative" or "derivatives transaction" as used in this Release means a "derivatives transaction," as defined in proposed rule 18f-4(c)(2), which describes derivatives that impose a payment obligation on the fund.

64 As we explained in Release 10666, we believe that an evidence of indebtedness, for purposes of section 18, includes not only a firm and un-contingent obligation, but also a contingent obligation, such as the obligation created by a standby commitment or a "put" (or call) option sold by a fund. *See* Release 10666, *supra* note 20, at "Standby Commitment Agreements" discussion. We understand that it has been asserted that a contingent obligation created by a standby commitment or similar agreement does not implicate section 18 unless and until the fund would be required under generally accepted accounting principles ("GAAP") to recognize the contingent obligation as a liability on the fund's financial statements. The treatment of derivatives transactions under GAAP, including whether the derivatives transaction constitutes a liability for financial statement purposes at any given time or the extent of the liability for that purpose, is not determinative with respect to whether the derivatives transaction involves the issuance of a senior security under section 18. This is consistent with our analysis of a fund's obligation, and the corresponding segregated asset amounts, under the trading practices described in Release 10666. *See supra* note 47 (describing the amount of assets to be segregated for the trading practices described in Release 10666, including that a fund should segregate the full purchase price of a standby commitment beginning on the date the fund entered into the agreement, which would represent a contingent obligation of the fund).

considered securities under other provisions of the federal securities laws.[65] For example, section 18(f)(1) generally prohibits an open-end fund from issuing or selling any senior security "except [that the fund] shall be permitted to borrow from any bank."[66] This statutory permission to engage in a specific borrowing makes clear that such borrowings are senior securities, which otherwise would be prohibited absent this specific permission.[67] Section 18(c)(2) similarly treats all promissory notes or evidences of indebtedness issued in consideration of any loan as senior securities except as specifically otherwise provided in that section.[68]

This view also is consistent with the fundamental statutory policy and purposes underlying the Act, as expressed in section 1(b) of the Act. Section 1(b) provides that the provisions of the Act shall be interpreted to mitigate and "so far as is feasible" to eliminate the conditions and concerns enumerated in that section. These include the conditions and concerns enumerated in sections 1(b)(7) and 1(b)(8) which declare, respectively, that "the national public interest and the interest of investors are adversely affected" when funds "by excessive borrowing

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65 Consistent with Release 10666, we are only expressing our views concerning section 18 of the Investment Company Act.

66 Recognizing the breadth of the term "senior security," we observed in the Concept Release that, "[t]o address [Congress' concerns underlying section 18], section 18(f)(1) of the Investment Company Act prohibits an open-end fund from issuing or selling any 'senior security' other than borrowing from a bank." (footnotes omitted)

67 We similarly observed in Release 10666 that section 18(f)(1), "by implication, treats all borrowings as senior securities," and that "[s]ection 18(f)(1) of the Act prohibits such borrowings unless entered into with banks and only if there is 300% asset coverage on all borrowings of the investment company." *See* Release 10666, *supra* note 20, at "Reverse Repurchase Agreements" discussion.

68 Section 18(c) provides further limitations on a closed-end fund's ability to issue senior securities, in addition to the asset coverage and other limitations provided in section 18(a), with the proviso in section 18(c)(2) that "promissory notes or other evidences of indebtedness issued in consideration of any loan, extension, or renewal thereof, made by a bank or other person and privately arranged, and not intended to be publicly distributed, shall not be deemed to be a separate class of senior securities representing indebtedness within the meaning of [section 18(c)]."

and the issuance of excessive amounts of senior securities increase unduly the speculative character" of securities issued to common shareholders and when funds "operate without adequate assets or reserves." Funds' obligations under derivative transactions can implicate each of these concerns.

As we stated in Release 10666, leveraging an investment company's portfolio through the issuance of senior securities "magnifies the potential for gain or loss on monies invested and therefore results in an increase in the speculative character of the investment company's outstanding securities" and "leveraging without any significant limitation" was identified "as one of the major abuses of investment companies prior to the passage of the Act by Congress." We emphasized in Release 10666, and we continue to believe today, that the prohibitions and restrictions under the senior security provisions of section 18 should "function as a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock" and that funds should not "operate without adequate assets or reserves."[69] Funds' use of derivatives, like the trading practices we addressed in Release 10666, implicate the undue speculation concern expressed in section 1(b)(7) and the asset sufficiency concern expressed in section 1(b)(8) as discussed below.

First, with respect to the undue speculation concern expressed in section 1(b)(7), we noted above and in the Concept Release that a common characteristic of most derivatives is that they involve leverage or the potential for leverage because they typically enable the fund to participate in gains and losses on an amount that substantially exceeds the fund's investment while imposing a conditional or unconditional obligation on the fund to make a payment or deliver assets to a counterparty. For example, a fund can enter into a total return swap

69 *See* Release 10666, *supra* note 20, at "Segregated Account" discussion.

referencing an equity or debt security and, in exchange for a contractual obligation to make payments in respect of changes in the value of the referenced security and the delivery of a limited amount of collateral, obtain exposure to the full notional value of the referenced security.[70] As one commenter observed, "a fund's purchase of an equity total return swap produces an exposure and economic return substantially equal to the exposure and economic return a fund could achieve by borrowing money from the counterparty in order to purchase the equities that are reference assets."[71] This same analysis applies to various other types of derivatives under which the fund posts a small percentage of the notional amount as initial margin or collateral—or is not required to make any up-front payment or receives a premium payment—but is exposed to the gains or losses on the full notional amount of the reference asset.[72]

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70 *See, e.g., The Report of the Task Force on Investment Company Use of Derivatives and Leverage,* Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) ("2010 ABA Derivatives Report"), *available at* https://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf, at 8 (stating that "[f]utures contracts, forward contracts, written options and swaps can produce a leveraging effect on a fund's portfolio" because "for a relatively small up-front payment made by a fund (or no up-front payment, in the case with many swaps and written options), the fund contractually obligates itself to one or more potential future payments until the contract terminates or expires"). *See also infra* notes 72-74.

71 BlackRock Concept Release Comment Letter, at 4.

72 *See, e.g., Board Oversight of Derivatives*, Independent Directors Council Task Force Report (July 2008) ("2008 IDC Report"), *available at* http://www.ici.org/pdf/ppr_08_derivatives.pdf, at 3 ("The leverage inherent in these [derivatives] instruments magnifies the effect of changes in the value of the underlying asset on the initial amount of capital invested. For example, an initial 5% collateral deposit on the total value of the commodity would result in 20:1 leverage, with a potential 80% loss (or gain) of the collateral in response to a 4% movement in the market price of the underlying commodity."); Andrew Ang, Sergiy Gorovyy & Gregory B. van Inwegen, *Hedge Fund Leverage*, NBER Working Paper 16801 (Feb. 2011) ("Ang, Gorovyy & Inwegen"), *available at* http://www.nber.org/papers/w16801.pdf, at Table 1 (showing that under prevailing margin rates as of March 2010, a market participant could in theory obtain 10 times implied leverage under a total return swap (because the exposure under the swap would be ten times the initial margin amount); 33 times implied leverage under a financial future; and 100 times implied leverage under a foreign exchange or interest rate swap).

As discussed in more detail in sections II.D and III.B.1.c, our staff's evaluation of the use of derivatives by funds also indicates that some funds make extensive use of derivatives to obtain notional investment exposures far in excess of the funds' respective net asset values.[73] Our staff's review of funds' use of derivatives found that, although many funds do not use derivatives, and most funds do not use a substantial amount of derivatives, some funds do use derivatives extensively. Some of the funds that use derivatives more extensively have derivatives notional exposures that are substantially in excess of the funds' net assets, with notional exposures ranging up to almost ten times a fund's net assets.[74] These highly leveraged investment exposures appear to be inconsistent with the purposes and concerns underlying section 18 of the Act.[75]

We noted in Release 10666 that, given the potential for reverse repurchase agreements to be used for leveraging and their ability to magnify the risk of investing in a fund, "one of the important policies underlying section 18 would be rendered substantially nugatory" if funds' use of reverse repurchase agreements were not subject to limitation. We similarly believe that if funds' use of derivatives that impose a future payment obligation on the fund were not viewed as involving senior securities subject to appropriate limitations under section 18, the concerns

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73 For more information on the staff's review, including the staff's measurement of derivatives exposures, *see infra* section III.B.1.c and the White Paper entitled "Use of Derivatives by Investment Companies," which was prepared by staff in the Division of Economic and Risk Analysis ("DERA") and will be placed in the comment file for this Release contemporaneously with our publication of the Release. Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost *Use of Derivatives by Registered Investment Companies* Division of Economic and Risk Analysis (2015) ("DERA White Paper"), *available at* http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

74 *Id.*

75 *See also infra* section II.D (discussing concerns with the current approach and providing examples of situations in which funds' use of derivatives has led to substantial losses).

underlying section 18, including the undue speculation concern expressed in section 1(b)(7) as discussed above, would be frustrated.[76]

Second, a fund's use of derivatives under which the fund has a future payment obligation also raises concerns with respect to a fund's ability to meet its obligations, implicating the asset sufficiency concern expressed in section 1(b)(8) of the Act. Many derivatives investments entered into by a fund, such as futures contracts, swaps, and written options, pose a risk of loss that can result in payment obligations owed to the fund's counterparties.[77] Losses on derivatives therefore can result in payment obligations that can directly affect the capital structure of a fund and the relative rights of the fund's counterparties and fund shareholders, in that the fund would be required to make payments or deliver fund assets to its derivatives counterparties under the terms negotiated with its counterparties. Because of the leverage present in many types of derivatives as discussed above, these senior payments of additional collateral or termination payments to counterparties can be substantially greater than any collateral initially delivered by the fund to initiate the derivatives transaction.[78]

Losses on a fund's derivatives transactions, and the resulting payment obligation imposed on the fund, can force a fund's adviser to sell the fund's investments to generate liquid assets in

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76 One commenter made this point directly. *See* Comment Letter of Stephen A. Keen on Concept Release (Nov. 8, 2011) (File No. S7-33-11) ("Keen Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-45.pdf, at 3 ("If permitted without limitation, derivative contracts can pose all of the concerns that section 18 was intended to address with respect to borrowings and the issuance of senior securities by investment companies."). *See also*, *e.g.*, ICI Concept Release Comment Letter, at 8 ("The Act is thus designed to regulate the degree to which a fund issues any form of debt—including contractual obligations that could require a fund to make payments in the future.").

77 Some derivatives transactions, like physically settled futures and forwards, can require the fund to deliver the underlying reference assets regardless of whether the fund experiences losses on the transaction.

78 *See*, *e.g.*, *supra* note 72.

order for the fund to meet its obligations. The use of derivatives for leveraging purposes can exacerbate this risk and make it more likely that a fund would be forced to sell assets, potentially generating losses for the fund.[79] In an extreme situation, a fund could default on its payment obligations.[80] The risks associated with derivatives transactions that impose a payment obligation on the fund differ from the risk of loss on other investments, which may result in a loss of asset value but would not require the fund to deliver cash or assets to a counterparty. The examples of fund losses discussed below in section II.D demonstrate the substantial and rapid losses that can result from a fund's investments in derivatives, as well as the forced sales and other measures a fund may be required to take to meet its derivatives payment obligations, implicating the undue speculation concern expressed in section 1(b)(7) and the asset sufficiency concern expressed in section 1(b)(8).[81]

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79 *See, e.g.*, Peter Breuer, *Measuring Off-Balance-Sheet Leverage*, IMF Working Paper (Dec. 2000) ("Off-Balance-Sheet Leverage IMF Working Paper"), *available at* http://www.imf.org/external/pubs/ft/wp/2000/wp00202.pdf, at 7-8 ("[A] more leveraged investor facing a given adverse price movement may be forced by collateral requirements (i.e. margin calls) to unwind the position sooner than if the position were not leveraged. The unwinding decision of an unleveraged investor depends merely on the investor's risk preferences and not on potentially more restrictive margin requirements.").

80 *See, e.g.*, ICI Concept Release Comment Letter, at 11 (noting that, "[h]ypothetically, in an extreme scenario, a fund that used derivatives heavily and segregated most of its liquid assets to cover its obligation on a pure mark-to-market basis could potentially find itself with insufficient liquid assets to cover its derivative positions").

81 In this regard, we note that proposed rule 22e-4 would, among other things, require an open-end fund (other than a money market fund) to (i) classify, and review on an ongoing basis the classification of, the liquidity of each of the fund's portfolio positions (or portions of a position), including derivatives, into one of six liquidity categories, and (ii) assess and periodically review the fund's liquidity risk, considering various factors specified in the rule, including the fund's use of borrowings and derivatives for investment purposes. Assessing liquidity risk under rule 22e-4 would involve an assessment of the fund's derivatives positions themselves, and also may generally include an evaluation of the potential liquidity demands that may be imposed on the fund in connection with its use of derivatives. To the extent the fund is required to make payments to a derivatives counterparty, those assets would not be available to meet shareholder redemptions. *See* Liquidity Release, *supra* note 5, at sections III.B.2. and III. C.1.c.

We recognize, however, that not every derivative will involve the issuance of a senior security because not every derivative imposes a future payment obligation on the fund. A fund that purchases an option, for example, generally will make a non-refundable premium payment to obtain the right to acquire (or sell) securities under the option but generally will not have any subsequent obligation to deliver cash or assets to the counterparty unless the fund chooses to exercise the option. A derivative that does not impose a future payment obligation on a fund in this respect generally resembles non-derivative securities investments in that these investments may lose value but will not require the fund to make any payments in the future.[82] Consistent with the views expressed by commenters, we preliminarily believe that a derivative that does not impose a future payment obligation on the fund would not involve a senior security transaction for purposes of section 18.[83]

### C. Review of Funds' Use of Derivatives

As we explained in the Concept Release, we now seek to take an updated and more comprehensive approach to the regulation of funds' use of derivatives.[84] To inform our

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82 At least one commenter on the Concept Release asserted that a purchased option would impose a payment obligation on the fund because "[i]f the option is in the money at the time it expires, the fund's manager has a fiduciary obligation to realize the intrinsic value of the option" and "to exercise the option, the fund must either pay the full strike price (for a call) or deliver the notional amount of the underlying asset (for a put)." *See* Keen Concept Release Comment Letter, at 16.

83 *See, e.g.*, ICI Concept Release Comment Letter, at 8 ("The Act is thus designed to regulate the degree to which a fund issues any form of debt—including contractual obligations that could require a fund to make payments in the future. By adopting a definition of 'leverage' in the context of section 18 that relates solely to indebtedness leverage and clearly distinguishes it from economic leverage, the Commission could alleviate some of the confusion in this area while appropriately protecting investors and serving the purposes of the Act."). Although some derivatives instruments may not involve the issuance of a senior security for purposes of section 18, we generally would expect the fund's adviser to consider the potential risks associated with these instruments, including the "economic" leverage they involve.

84 *See* Concept Release, *supra* note 3, at section I ("The Commission or its staff, over the years, has addressed a number of issues relating to derivatives on a case-by-case basis. The Commission now seeks to take a more comprehensive and systematic approach to derivatives-related issues

consideration of the regulation of funds' use of derivatives, we initiated a review of funds' use of derivatives under the Investment Company Act. As we noted in the Concept Release, our staff has been exploring the benefits, risks, and costs associated with funds' use of derivatives, as well as various issues relating to the use of derivatives by funds, including whether funds' current practices, based on their application of Commission and staff guidance, are consistent with the investor protection purposes and concerns underlying section 18 of the Investment Company Act.

In considering these and other issues, our staff has engaged in a range of activities to inform our policymaking relating to the use of derivatives by funds. These include reviewing funds' derivatives holdings and other sources of information concerning funds' use of derivatives; examining advisers to funds that make use of derivatives; discussing funds' use of derivatives with market participants; and considering other relevant information provided to the Commission concerning funds' use of derivatives, including comment letters submitted in response to the Concept Release. This review has also included an evaluation of the comment letters submitted in response to a notice issued by the Financial Stability Oversight Council ("FSOC") requesting comment on aspects of the asset management industry.[85] Although our proposal is independent of FSOC, some commenters responding to the FSOC notice discussed issues concerning leverage, and we have considered and cited to relevant comments throughout this Release.[86]

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under the Investment Company Act.").

85 *See* Notice Seeking Comment on Asset Management Products and Activities 79 FR 77488 (Dec. 24, 2014) ("FSOC Request for Comment").

86 Comments submitted in response to the FSOC Notice are available at http://www.regulations.gov/#!docketDetail;D=FSOC-2014-0001.

The staff's review of funds' use of derivatives includes, as discussed below, a review of the derivatives and other holdings of a random sample of funds, as reported by those funds in their annual reports to shareholders. As part of this effort, the staff reviewed and compiled information concerning the holdings of randomly selected mutual funds (including a focused review and separate sampling of alternative strategy funds[87]), closed-end funds, ETFs, and BDCs. Information derived from this review is discussed throughout this Release, and more details concerning the staff's review and findings are provided in the DERA White Paper, which was prepared by staff in the Division of Economic and Risk Analysis and which will be placed in the comment file for this Release contemporaneously with our publication of the Release.[88] As discussed below, in developing proposed rule 18f-4, we considered the information derived from our staff's review concerning funds' use of derivatives and other considerations, including the investor protection purposes and concerns underlying section 18 as reflected in sections 1(b)(7) and 1(b)(8).

## D. Need for a New Approach

### 1. *The Current Regulatory Framework and the Purposes and Policies Underlying the Act*

#### a. Background and Overview

We have determined to propose a new approach to funds' use of derivatives in order to address the investor protection purposes and concerns underlying section 18 of the Act and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions in light of the dramatic growth in the volume and complexity of the

87 We refer to alternative strategy funds in the same manner as the staff classified "Alt Strategies" funds in the DERA White Paper, *supra* note 73, as including the Morningstar categories of "alternative," "nontraditional bond" and "commodity" funds.

88 *See supra* note 73.

derivatives markets over the past two decades and the increased use of derivatives by certain funds. In Release 10666, we took the position that funds might engage in the transactions described in that release using the segregated account approach, notwithstanding the limitations in section 18.[89] We took this position because we believed that the segregated account approach would address the investor protection purposes and concerns underlying section 18 by: (i) imposing a "practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock"; and (ii) "assur[ing] the availability of adequate funds to meet the obligations arising [from the transactions described in Release 10666]."[90]

We continue to believe that these are relevant considerations and that it may be appropriate for a fund to enter into transactions that create fund indebtedness, notwithstanding the prohibitions in section 18, if such transactions are subject both to a limit on leverage to prevent undue speculation and to measures designed to require the fund to have sufficient assets to meet its obligations.[91] We are concerned, however, that funds' current practices, including

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89 Section 18 provides very limited statutory permission for open-end funds to borrow from any bank subject to the 300% asset coverage requirement and excludes from the definition of the term "senior security" any loans made for temporary purposes by a bank or other person and privately arranged in an amount not exceeding 5% of total assets. Release 10666 thus provided guidance for certain transactions that would otherwise be prohibited under the requirements of section 18, and open-end funds have used this guidance to enter into derivatives transactions that would otherwise be prohibited under section 18. *See also infra* note 141.

90 Release 10666, *supra* note 20, at "Segregated Account" discussion. These concerns are reflected in sections 1(b)(7) and 1(b)(8) of the Act, as discussed above. We also noted in Release 10666 that "segregated accounts, if properly created and maintained, would limit the investment company's risk of loss." *Id.*

91 We also believe these considerations are relevant when considering, as we are required to do for this proposed rule for purposes of section 6(c) of the Act, whether it would be necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act to provide an exemption from the requirements of sections 18 and 61 of Act and the appropriate conditions for any exemption.

their application of the segregated account approach to certain derivatives transactions, in some cases may not adequately address these considerations.

The segregated account approach described in Release 10666 required a fund engaging in the transactions described in that release to segregate liquid assets, such as cash, U.S. government securities, or other appropriate high-grade debt obligations, equal in value to the full amount of the obligations incurred by the fund.[92] A fund segregating an amount of the highly liquid assets described in Release 10666 equal in value to the full amount of potential obligations incurred through the transactions described in Release 10666 would be subject to a practical limit on the amount of leverage the fund could obtain through those transactions. The fund would not be able to incur obligations in excess of liquid assets that the fund could place in a segregated account, which generally would limit the fund's obligations to the fund's net assets, even if the fund's net assets consisted solely of the high-quality assets we described in Release 10666.[93] Segregating liquid assets equal in value to the full amount of the fund's obligations—and doing so with the types of high-quality liquid assets we described in Release 10666—also provided assurances that the fund would have adequate assets to meet its obligations.[94] The liquid assets we described in Release 10666 generally are less likely to experience volatility or to decline in value than lower quality debt securities or equity securities, for example, and the amount of the

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92 *See* Release 10666, *supra* note 20, at "Segregated Account" discussion. *See also supra* note 47.

93 *See, e.g.*, Ropes & Gray Concept Release Comment Letter, at 3 (in the context of Release 10666 "[a]s originally conceived by the Commission," explaining that "[a]s a practical matter, requiring the segregation of assets but not limiting the permitted segregation to cash equivalents effectively permitted funds to incur investment leverage up to a theoretical limit equal to 100% of a fund's net assets.") In addition and as we explained in Release 10666, as the percentage of a fund's portfolio assets that are segregated increases, the fund's ability to meet current obligations, to honor requests for redemption, and to manage properly the investment portfolio in a manner consistent with its stated investment objective may become impaired. *See* Release 10666, *supra* note 20, at "Segregated Account" discussion.

94 *See also supra* note 47.

fund's obligation under the trading practices addressed in Release 10666 generally would be known at the outset of the transaction.[95]

Today, in contrast, many funds apply the mark-to-market segregation approach to certain net cash-settled derivatives, and some funds use this form of asset segregation extensively.[96] Under this approach, funds segregate an amount equal to the fund's daily mark-to-market liability on the derivative, if any.[97] Although funds initially applied this approach to a few specific types of transactions addressed through guidance by our staff (interest rate swaps, futures required to cash-settle and NDFs), many funds now apply mark-to-market segregation to other cash-settled instruments, including total return swaps ("TRS") and cash-settled written options.[98] As we noted above, our staff has observed that some funds appear to apply the mark-to-market approach to any derivative that is cash settled.

The amount of assets that a fund would segregate under the mark-to-market approach is substantially less than under the approach contemplated in Release 10666. The mark-to-market approach therefore allows a fund to obtain greater exposures through derivatives transactions than the fund could obtain using the approach we contemplated in Release 10666 with respect to the trading practices described in that release, and also may result in a fund segregating an amount of assets that may not be sufficient to enable the fund to meet its potential obligations under the derivatives transactions, as discussed below.

In addition to the smaller amount of segregated assets under the mark-to-market approach, funds now segregate various types of liquid assets, rather than the more narrow range

95 *See also*, *e.g.*, *infra* note 115 and accompanying text.

96 *See supra* notes 56-58 and accompanying text.

97 *Id.*

98 *Id.*

of high-quality assets described in Release 10666, in reliance on a no-action letter issued by our staff.[99] A fund that segregates any liquid asset may be able to obtain greater leverage than a fund that segregates only the types of assets we described in Release 10666, especially when the fund also is applying the mark-to-market segregation approach.[100] This is because a fund segregating only the types of assets we described in Release 10666 would be more constrained in its ability to enter into transactions requiring asset coverage by the requirement to maintain those kinds of high-quality assets. A fund that segregates any liquid asset, in contrast, may invest in various types of securities, consistent with its investment strategy, while potentially also using a large portion of its portfolio to cover transactions implicating section 18.[101] This facilitates the fund's ability to obtain leverage because the fund, by using securities consistent with its strategy to cover derivatives transactions, can add additional exposure through derivatives without having to also maintain lower-risk assets.[102]

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99 *See* Merrill Lynch No-Action Letter, *supra* note 59 (staff no-action letter in which the staff took the position that a fund could cover its derivatives-related obligations by depositing any liquid asset, including equity securities and non-investment grade debt securities, in a segregated account).

100 *See, e.g.*, Vanguard Concept Release Comment letter, at 6 ("[The Merrill Lynch No-Action Letter] greatly increased the amount funds could invest in derivatives because most of a fund's portfolio securities could be used to cover its derivatives positions."); Ropes & Gray Concept Release Comment Letter, at 3 ("The Staff's subsequent no-action letter issued to Merrill Lynch in 1996 provided greater flexibility by allowing a fund to segregate any liquid assets, including equity securities and non-investment grade debt -- thus potentially expanding the nature of the investment leverage risks associated with derivatives."); 2010 ABA Derivatives Report, *supra* note 70, at 14 ("This position [taken in the Merrill Lynch No-Action Letter] greatly increased the degree to which funds could use derivatives because all or substantially all of their portfolio securities could be used to 'cover' their derivatives positions.").

101 *See, e.g.*, *id.*

102 For example, in a settled enforcement action discussed below involving funds that obtained exposure to certain commercial mortgage-backed securities ("CMBS") mainly through TRS contracts, our order issued in connection with the matter noted that, unlike an actual purchase of CMBS, the TRS contracts required no initial commitment of cash, which allowed the funds to take on large amounts of CMBS exposure without having to liquidate other positions, but it also caused them to take on leverage by adding market exposure on top of other assets on their

b. Concerns Regarding Funds' Ability to Obtain Leverage

Together, funds' use of the mark-to-market segregation approach with respect to various types of derivatives, plus the segregation of any liquid asset, enables funds to obtain leverage to a greater extent than was contemplated in Release 10666. Segregating only a fund's daily mark-to-market liability—and using any liquid asset—enables the fund, using derivatives, to obtain exposures substantially in excess of the fund's net assets.[103] For derivatives for which there is no loss for a given day, a fund applying the mark-to-market approach might not segregate *any* assets.[104] This may be the case, for example, because the derivative is currently in a gain position, or because the derivative has a market value of zero (as will generally be the case at the inception of a transaction). The mark-to-market approach therefore generally will not limit a fund's ability to obtain substantial exposures through derivatives.

To evaluate the extent of funds' derivatives exposure, our staff reviewed funds' holdings and compared the amount of exposure under the funds' derivatives, based on the derivatives' notional amounts, with the fund's net assets.[105] As discussed in more detail in the DERA White

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balance sheets. *See infra* note 123 and accompanying text.

103 *See, e.g.*, Ropes & Gray Concept Release Comment Letter, at 3 (in the context of Release 10666 "[a]s originally conceived by the Commission," explaining that "[a]s a practical matter, requiring the segregation of assets but not limiting the permitted segregation to cash equivalents effectively permitted funds to incur investment leverage up to a theoretical limit equal to 100% of a fund's net assets"; also noting that "industry practice has evolved further since 1996 [when the staff issued the Merrill Lynch No-Action Letter, *supra* note 59] in a manner that could, in some instances, allow for investment leverage that exceeds the 100% limit that was implicit in earlier Commission and Staff positions".).

104 The fund may, however, still be required to post collateral to comply with other regulatory or contractual requirements. *See, e.g.*, Comment Letter of Rafferty Asset Management, LLC on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("Rafferty Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-40.pdf, at 12 (noting that "all swap" contracts have an "out of the money value of the contract [of] zero" at inception, but that the firm's swap contracts "typically require the Funds to post collateral equal to approximately 20% of the notional value of the swap transaction").

105 Our staff also reviewed the extent to which funds used financial commitment transactions and the

Paper, our staff found that, although many funds do not use derivatives, and most funds do not use a substantial amount of derivatives, some funds do use derivatives extensively. Some of the funds making extensive use of derivatives obtained notional exposures through derivatives that were substantially in excess of their net assets under a mark-to-market approach and these funds could obtain even higher exposures by applying such an approach. Funds included in our staff's review sample had notional exposures ranging up to almost ten times a fund's net assets. Although we recognize that funds use derivatives for various reasons, a fund with derivatives notional exposures of almost ten times its net assets and having the potential for additional exposures, for example, does not appear to be subject to a practical limit on leverage as we contemplated in Release 10666.[106]

Funds are able to obtain such high levels of derivatives exposures relative to the funds' net assets primarily because of their use of the mark-to-market approach with respect to various types of derivatives, as discussed above.[107] We observed the argument in the Concept Release that segregating only the mark-to-market liability "may understate the risk of loss to the fund

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extent to which the funds entered into other types of senior securities transactions pursuant to section 18 or 61.

106 *See*, *e.g.*, Ropes & Gray Concept Release Comment Letter, at 4 (noting that "[i]t now appears to be an increasingly common practice for funds that engage in cash-settled swaps to segregate assets only to the extent required to meet the fund's daily mark-to-market liability, if any, relating to such swaps" but that, "[o]f course, in many cases this liability will not fully reflect the ultimate investment exposure associated with the swap position" and that, "[a]s a result, a fund that segregates only the market-to-market liability could theoretically incur virtually unlimited investment leverage using cash-settled swaps"); Keen Concept Release Comment Letter, at 20 (stating that the mark-to-market approach, as applied to cash settled swaps, "imposes no effective control over the amount of investment leverage created by these swaps, and leaves it to the market to limit the amount of leverage a fund may use").

107 Our staff also has stated that it would not object to a fund covering its obligations by entering into certain cover transactions or holding the asset (or the right to acquire the asset) that the fund would be required to deliver under certain derivatives. *See supra* note 53. *See also infra* section III.B.1.d.

[and] permit the fund to engage in excessive leveraging . . . ."[108] Concerns about the efficacy of the mark-to-market approach may be exacerbated by funds' application of the mark-to-market approach to TRS in particular. This greatly expands the potential use of the mark-to-market approach because a TRS can reference any asset, including a range of securities, commodities, or other derivatives.[109] Nearly any type of investment that a fund could make directly can be transformed into a cash-settled TRS which, as noted above, may "produce[] an exposure and economic return substantially equal to the exposure and economic return a fund could achieve by borrowing money from the counterparty in order to purchase the equities that are reference assets" under the TRS.[110]

c. Concerns Regarding Funds' Ability to Meet Their Obligations

Funds' current practices also may not "assure the availability of adequate [assets] to meet the obligations arising from [funds' derivatives transactions]," as we contemplated in Release 10666, and thus may implicate the asset sufficiency concern expressed in section 1(b)(8) of the Act. In Release 10666, we stated a fund should segregate liquid assets equal in value to the fund's full obligation under the transactions described in that release from the outset of the transaction.[111] Consistent with Release 10666, funds applying the notional amount segregation approach segregate an amount of assets equal in value to the full amount of the fund's potential

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108 *See* Concept Release, *supra* note 3, at text accompanying n.83. *See also supra* note 106.

109 When a fund purchases a total return swap, the fund agrees with a counterparty that the fund will periodically pay a specified fixed or floating rate and will receive any appreciation and any interest or dividend payments on a specified reference asset(s), and will pay any depreciation on the reference asset(s). *See*, *e.g.*, ISDA Product Descriptions and Frequently Asked Questions, *available at* http://www.isda.org/educat/faqs.html#28 ("A total return swap is a agreement in which one party (total return payer) transfers the total economic performance of a reference obligation to the other party (total return receiver). Total economic performance includes income from interest and fees, gains or losses from market movements, and credit losses.").

110 *See* BlackRock Concept Comment Letter, at 4 and accompanying text.

111 *See supra* note 47.

obligation under derivatives, where that amount is known at the outset of the transaction, or the full market value of the underlying reference asset for the derivative.[112] Segregating assets equal in value to the fund's full potential obligation under a derivative generally would be expected to enable the fund to meet that obligation.

A fund using the mark-to-market approach, however, segregates assets the fund deems liquid in an amount equal to the fund's daily mark-to-market liability on the derivative, if any. This approach looks only to losses, and corresponding potential payment obligations under the derivative, that the fund already has incurred. A fund that follows this approach is not necessarily segregating assets in anticipation of possible future losses and any corresponding payment obligations, and the fund's segregation of assets equal to its mark-to-market liability on any particular day provides no assurances that future losses will not exceed the amount of assets the fund has segregated or would otherwise have available to meet the payment obligations resulting from such losses. A fund's mark-to-market liability on any particular day could be substantially smaller than the fund's ultimate obligations under a derivative.[113] As noted above,

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112 *See supra* notes 54-55 and accompanying text.

113 *See, e.g.*, ICI Concept Release Comment Letter, at 11 (noting that "calculating a fund's exposure daily based only on its net obligations—the 'mark-to-market' approach—may create a risk that market movements could increase a fund's exposure, so that the segregated assets are worth less than the fund's obligation" and that "[h]ypothetically, in an extreme scenario, a fund that used derivatives heavily and segregated most of its liquid assets to cover its obligation on a pure mark-to-market basis could potentially find itself with insufficient liquid assets to cover its derivative positions"); Vanguard Concept Release Comment Letter, at n.15 (noting that "using a market value [asset segregation] test for certain transactions can result in the under-segregation of assets"); AQR Concept Release Comment Letter, at 4 ("The current asset segregation approach, while it has been effective in mitigating the risks section 18 was designed to address (*i.e.,* excessive borrowing and operating without adequate assets and reserves), has some weaknesses. In particular, as applied to swaps, the daily end-of-day segregation of changes in market value do not reflect the likelihood of loss or volatility of the reference instrument. Intra-day value fluctuations are ignored. For futures, the issues are similar."); Ropes & Gray Concept Release Comment Letter, at 4 (noting that a swap's mark-to-market liability, if any, "in many cases . . . will not fully reflect the ultimate investment exposure associated with the swap position").

if there is no mark-to-market liability for the fund on a given day, for example because the derivative is currently in a gain position or the fund has just entered into a derivative like a swap for which there is no daily loss for either party at inception, the fund might not segregate *any* assets.[114]

Where a fund segregates any liquid asset, rather than the more narrow range of high-quality assets we described in Release 10666, the segregated assets may be more likely to decline in value at the same time as the fund experiences losses on its derivatives than if the fund had segregated the types of liquid assets we described in Release 10666.[115] In this case, or when a fund's derivatives payment obligations are substantial relative to the fund's assets, the fund may be forced to sell portfolio securities to meet its derivatives payment obligations, potentially in stressed market conditions.[116] That a fund has segregated assets it deems sufficiently liquid to

114 *See supra* note 104 and accompanying text.

115 *See, e.g.*, Comment Letter of Better Markets, Inc. on Concept Release (Nov. 7, 2011) (File No. S7-33-11), *available at* http://www.sec.gov/comments/s7-33-11/s73311-42.pdf, at 5 (stating that "the broadening of segregated assets [permitted by the Merrill Lynch No-Action letter] increases the probability that the embedded credit associated with the derivatives will result in a senior payment of money from the Funds" . . . and, in addition, "the assets could be positively correlated with the derivatives risk being offset" and that "[l]oss on the derivatives risk could be compounded by loss on the asset"); 2010 ABA Derivatives Report, *supra* note 70, at 16 (where only the mark-to-market liability, if any, is segregated, "a fund's exposure under a derivative contract could increase significantly on an intraday basis, resulting in the segregated assets being worth less than the fund's obligations (until the fund is able to place additional assets in the segregated account . . . . To the extent that a fund relying on the Merrill Lynch Letter segregates assets whose prices are somewhat volatile, this 'shortfall' could be magnified").

116 We noted in Release 10666 that "in an extreme case an investment company which has segregated all its liquid assets might be forced to sell non-segregated portfolio securities to meet its obligations upon shareholder requests for redemption. Such forced sales could cause an investment company to sell securities which it wanted to retain or to realize gains or losses which it did not originally intend." *See* Release 10666, *supra* note 20, at "Segregated Account" discussion. *See also infra* note 123 and accompanying text.

cover a derivative's daily mark-to-market liability, if any, thus may not effectively assure the fund will have liquid assets to meet its future obligations under the derivative.[117]

Some commenters on the Concept Release appear to have recognized that segregation of a fund's daily mark-to-market liability alone may not be sufficient in at least some cases. As discussed in more detail below in section III.C of this Release, some commenters have suggested that we impose asset segregation requirements under which a fund would include in its segregated account for a derivative an amount determined by the fund, in addition to the daily mark-to-market liability, designed to address future losses.[118] Some commenters stated that it may be appropriate for a fund to maintain this additional amount, sometimes referred to as a "cushion" by commenters, in addition to assets used to cover any daily mark-to-market liability.[119] Some of these commenters further recommended that such an asset segregation

117 *See, e.g.*, Keen Concept Release Comment Letter, at 20 ("The out-of-the money value of a swap [segregated under the mark-to-market approach] only represents how much the fund *already* has lost, not the *potential* loss that might be incurred during the term of the swap. The potential loss represents the risk of investment leverage, but the Division's position [regarding the mark-to-market approach] does not require the fund to maintain any assets to cover this risk. The only practical limit is the fund's need to maintain a buffer of unsegregated assets to cover fluctuations in the swap's out-of-the-money value.") (emphasis in original); MFDF Concept Release Comment Letter, at 4 ("A fund can also have significant liability exposures connected with a derivative position, particularly if that position does not perform as expected. Because the extent of these liabilities can far outweigh the initial investment in the instrument, the use of derivatives raises potentially serious concerns under the Investment Company Act of 1940 . . . .").

118 *See, e.g.*, ICI Concept Release Comment Letter; Comment Letter of Invesco Advisers, Inc. on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("Invesco Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-20.pdf (supporting the ICI's recommendation concerning asset segregation); BlackRock Concept Release Comment letter; Comment Letter of Securities Industry and Financial Markets Association on Concept Release (Nov. 23, 2011) (File No. S7-33-11) ("SIFMA Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-51.pdf; Vanguard Concept Release Comment Letter.

119 *See, e.g.*, ICI Concept Release Comment Letter, at 3 ("When segregating less than the most conservative full notional amount, the segregation policy should require a more in depth analysis to ensure that the fund has a 'cushion' to address the potential loss from derivative contracts that could arise before the next time obligations are marked to market (often, the end of the next day);

requirement be complemented by additional guidance or requirements, with at least one commenter suggesting that we may wish to consider also imposing an "overall leverage limit."[120]

For all of these reasons, funds' current practices, based on their application of Commission and staff guidance, may in some cases fail to impose an effective limit on the amount of leverage that funds can obtain through derivatives or necessarily require that funds have adequate assets to meet their obligations arising under the derivatives transactions.[121] This is not consistent with our stated expectations in Release 10666 that funds' use of the segregated account approach as described in that release would achieve these goals, consistent with the undue speculation concern expressed in section 1(b)(7) and the asset sufficiency concern expressed in section 1(b)(8).[122]

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SIFMA Concept Release Comment Letter, at 4 ("The 'cushion' would address some potential shortcomings of a simple mark-to-market value measure, such as the risk that a Fund's indebtedness under a derivative could increase significantly on an intraday basis, resulting in a gap between the value of a Fund's segregated assets and its actual payment obligations under the derivative.").

120 *See* Vanguard Concept Release Comment Letter, at n.18 ("We recognize that the SEC may have concerns about allowing funds to develop their own asset segregation approach based upon SEC examples. To allay those concerns, the SEC may wish to consider adopting an overall leverage limit that funds would be required to comply with, notwithstanding that they have segregated liquid assets to back their obligations."). *See also, e.g.*, ICI Concept Release Comment Letter, at 12 ("For funds that choose to segregate assets at less than the most conservative levels, we recommend that the SEC or its staff set forth general guidance that provides 'guardrails' to ensure appropriate protections for investors.").

121 We observed in the Concept Release the concern that the mark-to-market segregation approach, which we understand is increasingly used by funds with respect to various derivatives, "may understate the risk of loss to the fund, permit the fund to engage in excessive leveraging, fail to adequately set aside sufficient assets to cover the fund's ultimate exposure, and, therefore, perhaps not adequately fulfill the purposes underlying the segregated account approach and section 18." *See* Concept Release, *supra* note 3, at text accompanying n.83.

122 *See* Release 10666, *supra* note 20, at "Segregated Account" discussion (stating that "[i]f an investment company continues to engage in the described securities trading practices and properly segregates assets, the segregated account *will* function as a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock" and that "such accounts *will* assure the availability of adequate funds to meet the obligations arising from such activities") (emphasis

d. Examples of Substantial Derivatives-Related Losses

Three relatively recent settled enforcement actions provide examples of situations in which funds' use of derivatives caused significant losses and are relevant to our consideration of whether funds' current practices, based on their application of Commission and staff guidance, are consistent with the investor protection purposes and concerns underlying section 18 of the Investment Company Act. The funds' experiences in these cases demonstrate the substantial and rapid losses that can result from a fund's investments in derivatives. The first action also demonstrates the further losses that can arise when a fund's portfolio securities also experience declines in value at the same time that the fund is required to make additional payments under the derivatives contracts.

The first action involved two mutual funds that suffered losses driven primarily by their exposure to certain commercial mortgage-backed securities ("CMBS"), obtained mainly through TRS.[123] Unlike an actual purchase of CMBS, these TRS contracts required no initial commitment of cash; this allowed the funds to take on large amounts of CMBS exposure without having to liquidate other positions, but it also caused them to take on leverage by adding market exposure on top of other assets on their balance sheets.

In late 2008, CMBS spreads widened to unprecedented levels, triggering substantial payment obligations for the funds under the TRS contracts while market values for the funds' portfolio securities also fell, further driving down the funds' net asset value per share. Amidst this declining market the funds also were required to sell portfolio securities to raise cash to meet their obligations under the TRS contracts. In addition, the adviser provided sponsor support to

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added).

123 *See* In the matter of OppenheimerFunds, Inc. and OppenheimerFunds Distributor, Inc., Investment Company Act Release No. 30099 (June 6, 2012) (settled action).

one of the funds by investing $150 million in the fund in November 2008 to provide the fund with liquidity after its anticipated TRS payments for that month totaled approximately one-third of the fund's net assets and almost twice its available cash. Both of the funds experienced losses far greater than those suffered by their peer funds. One fund's share price declined nearly 80% (compared to an average decline of approximately 26% among its peers), far more than any sector in which the fund invested. This occurred because the fund was substantially leveraged as a result of its derivatives, particularly TRS contracts. The other fund's share price declined approximately 36% (compared to an average decline of approximately 4% among its peers).

The second action[124] involved a registered closed-end fund that pursued an investment strategy involving written out-of-the money put options and short variance swaps.[125] These derivatives transactions led to substantial losses for the fund in September and October 2008, when the fund realized a loss of approximately $45.4 million, or 45% of the fund's net assets as of the end of August 2008, on five written put options and variance swaps, contributing to a 72.4% two-month decline in the Fund's net asset value. The fund was liquidated in May 2009.

The third action[126] involved a registered closed-end fund that primarily invested in distressed debt until 2008, when it changed course and shorted credit by purchasing large amounts of CDS. In 2008 and early 2009, the fund's short exposure significantly increased as a

124 *See* In the matter of Claymore Advisors, LLC, Investment Company Act Release No. 30308 (Dec. 19, 2012); In the matter of Fiduciary Asset Management, LLC, Investment Company Act Release No. 30309 (Dec. 19, 2012) (settled actions).

125 Variance swaps are essentially a bet on whether the actual or realized market volatility will be higher or lower than the market's expectation for volatility (or "implied volatility"). A party with a "long variance" position profits when realized volatility for the contract period is greater than the implied volatility. A party with a "short variance" position profits whenever realized volatility is less than the implied volatility.

126 *See* In the Matter of UBS Willow Management L.L.C. and UBS Fund Advisor L.L.C., Investment Company Act Release No. 31869 (Oct. 16, 2015) (settled action).

result of large CDS purchases. The large CDS portfolio dramatically changed the fund's risk profile. Starting around April 2009, credit conditions began to improve and distressed debt increased in value, leading to large mark-to-market losses for the fund's CDS portfolio. In addition, the high cost of maintaining the CDS positions contributed to the fund's losses. In 2012, the fund performed very poorly in large part because of its short-credit CDS portfolio, and the fund's board voted to liquidate the fund.

Examples of the use of derivatives by investment funds that are not subject to the limitations under the Investment Company Act, including private funds, such as hedge funds, that are excluded from regulation under the Investment Company Act by section 3(c)(1) or 3(c)(7) of the Act also may be relevant in considering registered funds' use of derivatives.[127] Private funds' experience with the use of derivatives can help demonstrate the risks associated with derivatives generally, and private funds' experience also may be more directly relevant to the extent registered funds are obtaining leverage to a similar extent as private funds and pursuing similar investment strategies.

As one example, a private fund with approximately $10.2 billion of net assets lost $4.9 billion in natural gas futures positions in a period of a few weeks in August and September 2006 and was forced to liquidate its entire portfolio and close.[128] While the fund engaged in a range of

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127 Section 3(c)(1) excludes from the definition of "investment company" any issuer whose outstanding securities 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 (other than short term paper). Section 3(c)(7) excludes 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. Private funds that rely on section 3(c)(1) or 3(c)(7) are not required to comply with any of the capital structure or leverage limitations under the Act, and the use of leverage by private funds, including hedge funds, may be an important component of their investment strategies.

128 *See* Ludwig B. Chincarini, *A Case Study on Risk Management: Lessons from the Collapse of*

investment strategies, its primary strategy involved a long-short strategy in one type of energy commodity—natural gas—that it traded through NYMEX futures and OTC swaps. The fund's exposure on its long and short natural gas positions in August 2006 could have been viewed as balanced or hedged at the time it made the investments, in that the fund reportedly had a net exposure that was much less substantial than the fund's substantial long and short gross exposures.[129] However, losses incurred on a portion of the fund's positions (which were not offset by gains on its other positions) resulted in substantial margin calls on the fund that it was unable to meet with its available cash, and the fund's adviser liquidated the fund's entire portfolio of natural gas positions and closed the fund, with losses to investors of almost 50% of the fund's net asset value.

This example demonstrates the challenges in assessing whether ostensibly hedged or covered positions will perform as intended (for example, whether a position intended to hedge another exposure may fail to have a hedging effect and instead result in additional, speculative exposure). In the example above, the private fund's adviser may have expected that the fund's long and short positions would hedge a substantial amount of the risk inherent in each set of positions, and this could have been the case under various circumstances. But it was not the case in August and September of 2006, when the fund experienced the substantial losses discussed above leading to its liquidation.

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*Amaranth Advisors L.L.C.*, 18 J. OF APPLIED FIN. 152 (Spring/Summer 2008), *available at* http://ludwigbc.com/pubs/pub9.pdf.

129 *See id.*, at 159 ("The position is 'hedged' in the sense that if natural gas futures prices rise or fall, one position's loss will be partly offset by the other's gain. However, the position is focusing on a spread bet.").

### 2. *Need for an Updated and More Comprehensive Approach*

We now propose to take an updated and more comprehensive approach to the regulation of funds' use of derivatives and the application of the senior security restrictions in section 18. The current approach has developed over the years since we issued Release 10666 as funds and our staff sought to apply our statements in Release 10666 to various types of derivatives and other transactions on an instrument-by-instrument basis. We understand that, in determining how they will comply with section 18, funds consider various no-action letters issued by our staff. These letters were issued in the 1970s, 1980s, and 1990s, and addressed particular questions presented to the staff concerning the application of the approach enunciated in Release 10666 to various types of derivatives on an instrument-by-instrument basis.[130] We understand that funds also consider, in addition to these letters, other guidance they may receive from our staff and the practices that other funds disclose in their registration statements.

The current approach's development on an instrument-by-instrument basis, together with the dramatic growth in the volume and complexity of the derivatives markets over the past two decades, has resulted in situations for which there is no specific guidance from us or our staff with respect to various types of derivatives.[131] We noted in the Concept Release the concern that the segregated account approach, by calling for an instrument-by-instrument assessment of the amount of cover required, may create uncertainty about the treatment of new products, and that

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130 *See Registered Investment Company Use of Senior Securities–Select Bibliography, available at* http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm (prepared by the staff and citing staff no-action letters).

131 *See*, *e.g.*, ICI Concept Release Comment Letter, at 9 ("A principles based approach is necessary because the SEC staff's traditional instrument by instrument approach to guidance has created, and would continue to create, regulatory uncertainty.").

new product development will inevitably lead to circumstances in which available guidance does not specifically address each new instrument subject to section 18 constraints.[132]

Under the current approach, different funds may treat the same kind of derivative differently, based on their own application of our staff's guidance and observation of industry practice, which at least one commenter noted "may unfairly disadvantage some funds."[133] Where there is no specific guidance, or where the application of existing guidance is unclear, funds may take approaches that involve a more extensive use of derivatives and that may not address the purposes and concerns underlying section 18 of the Act, as discussed above. The lack of guidance addressing some derivatives may create competitive pressures for funds to take approaches that involve a more extensive use of derivatives. The current approach, having developed over time, may treat similar derivatives in a manner that results in substantially different amounts of segregated assets, and may itself influence funds' investment decisions.[134] The lack of comprehensive guidance also makes it difficult for funds and our staff to evaluate and inspect for funds' compliance with section 18. A number of commenters on the Concept Release supported a more comprehensive and systematic approach, rather than an approach in

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132 *See* Concept Release, *supra* note 3, at n.79 and accompanying text.

133 *See, e.g.*, Davis Polk Concept Release Comment Letter, at 1-2 (noting that "funds and their sponsors may interpret the available guidance differently, even when applying it to the same instruments, which may unfairly disadvantage some funds").

134 *See, e.g.*, ICI Concept Release Comment Letter, at n.19 (noting that funds segregate the notional amount of physically settled futures contracts, consistent with the Dreyfus no-action letter, while some funds disclose that they segregate only the marked-to-marked obligation in respect of cash-settled futures and agreeing with the concern reflected in the Concept Release that this "results in differing treatment of arguably equivalent products"); Davis Polk Concept Release Comment Letter, at 3 (noting that "[t]he current approach to segregation leaves many open questions and may lead to inconsistent results for financially similar instruments," noting for example that very few funds use physically settled futures contracts because staff guidance has applied the notional segregation approach to these contracts and, "[i]nstead, funds enter into over-the-counter swaps that provide similar economic exposure, even though swaps tend to be more expensive and present other potential risks, such as counterparty risk and lack of liquidity").

which we or our staff provide guidance on an instrument-by-instrument basis, which these commenters generally suggested would be less effective.[135]

A fund's use of derivatives may involve counterparty, liquidity, leverage, market, and operational risks, as noted above. As we observed in the Concept Release, "[a] fund's use of derivatives presents challenges for its investment adviser and board of directors to ensure that the derivatives are employed in a manner consistent with the fund's investment objectives, policies, and restrictions, its risk profile, and relevant regulatory requirements, including those under federal securities laws."[136] In light of these considerations and those we discuss in section III.D below, we believe that funds that make significant use of derivatives, or that use certain complex derivatives, should have formalized risk management programs to manage the risks that

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135 *See*, *e.g.*, ICI Concept Release Comment Letter, at 9 (advocating for a principles-based approach and noting, among other things, that "the SEC staff's approach to date of providing guidance with respect to specific types of instruments has created a patchwork of interpretations that is neither practical nor sustainable"); Davis Polk Concept Release Comment Letter, at 1 (noting that while guidance from the Commission and staff "has been helpful, it has not been able to keep pace with the dramatic expansion of the derivatives market over the past twenty years, both in terms of the types of instruments that are available and the extent to which funds use them," and that resulting "regulatory uncertainty may lead a fund to select one type of instrument or transaction over another for non-investment reasons, or to avoid certain instruments or transactions altogether," which "can lead to inefficiencies that are detrimental to funds and their shareholders"); BlackRock Concept Release Comment Letter, at 5 ("Any set of mechanical rules cannot take account of the diversity of derivatives and the multiplicity of ways they may be used by portfolio managers."); Invesco Concept Release Comment Letter; Loomis Concept Release Comment Letter; Comment Letter of American Bar Association on Concept Release (Nov. 11, 2011) (File No. S7-33-11) ("ABA Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-47.pdf; MFDF Concept Release Comment Letter; Comment Letter of T. Rowe Price Associates, Inc. on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("T. Rowe Price Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-35.pdf; Vanguard Concept Release Comment Letter.

136 Concept Release, *supra* note 3, at 14. *See also*, *e.g.*, Comment Letter of Capital Market Risk Advisors on Concept Release (Nov. 1, 2011) (File No. S7-33-11), *available at* http://www.sec.gov/comments/s7-33-11/s73311-19.pdf (supporting risk management for derivatives, but also for all more complex and less liquid instruments).

derivatives may pose and to help address the challenges and investor protection concerns presented by their use.[137]

## III. DISCUSSION

As noted above, the dramatic growth in the volume and complexity of the derivatives markets over the past two decades, and the increased use of derivatives by certain funds, led us to initiate a review of funds' use of derivatives under the Investment Company Act. Based on that review, including the considerations we discussed in section II.D above and throughout this Release, we are today proposing rule 18f-4, an exemptive rule designed to address the investor protection purposes and concerns underlying section 18 and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions and financial commitment transactions. This proposal is part of a broader set of initiatives designed to address the increasingly complex portfolio composition and operations of the asset management industry.[138]

Proposed rule 18f-4 would permit a fund to enter into derivatives transactions, as defined in the rule, provided that the fund complies with three primary sets of conditions of the rule

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137 *See, e.g.*, Oppenheimer Concept Release Comment Letter, at 3 (stating that "a core component in the oversight of the use of derivatives by funds should be the board's awareness of the controls in place, and the effectiveness of the adviser's governance of risk in maintaining this awareness" and that "[w]e believe it is reasonable for the SEC to expect large and sophisticated investment advisers to have in place a well-developed risk governance framework incorporating an independent risk management function, governance structures designed to ensure the comprehensive review by appropriate levels of management of risk issues and reporting to a fund's board designed to facilitate and enhance effective board oversight").

138 Other initiatives include modernizing investment company reporting and disclosure and proposing liquidity risk management programs for open-end funds, including exchange-traded funds. *See* Investment Company Reporting Modernization, Investment Company Act Release No. 31610 (May 20, 2015) [80 FR 33590 (June 12, 2015)] ("Investment Company Reporting Modernization Release"); Amendments to Form ADV and Investment Advisers Act Rules, Advisers Act Release No. 4091 (May 20, 2015) [80 FR 33718 (June 12, 2015)]; Liquidity Release, *supra* note 5.

designed to address the purposes and concerns underlying section 18.[139] First, the fund would be required to comply with one of two alternative portfolio limitations designed to impose a limit on the amount of leverage the fund may obtain through derivatives transactions and other senior securities transactions. The first portfolio limitation would place an overall limit on the amount of exposure (as defined in the rule) to underlying reference assets, and potential leverage, that a fund would be able to obtain through derivatives transactions and other senior securities transactions by limiting the fund's exposure under these transactions to 150% of the fund's net assets. The second portfolio limitation would focus primarily on a risk assessment of the fund's use of derivatives, and would permit a fund to obtain exposure in excess of that permitted under the first portfolio limitation where the fund's derivatives transactions, in aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives, evaluated using a value-at-risk-based test.

Second, the fund would be required to manage the risks associated with the fund's derivatives transactions by maintaining an amount of certain assets, defined in the proposed rule as "qualifying coverage assets," designed to enable the fund to meet its obligations under its

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[139] The proposed rule would provide an exemption from certain provisions of section 18 and 61 of the Act, subject to conditions. The proposed rule could be used by any fund subject to the requirements of section 18 or 61, including mutual funds, closed-end funds, BDCs, most ETFs, and exchange-traded managed funds. (Exchange-traded managed funds, a hybrid between a traditional mutual fund and an ETF, are open-end funds that the Commission has approved. *See* Eaton Vance Management, et al., Investment Company Act Release Nos. 31333 (Nov. 6, 2014) (notice) and 31361 (Dec. 2, 2014) (order)). The rule would not apply to unit investment trusts ("UITs"), including ETFs structured as UITs, because UITs are not subject to the requirements of section 18. However, as the Commission has noted (in addressing futures contracts and commodities options), derivatives transactions generally require a significant degree of management and may not meet the requirements imposed on a UIT by the Investment Company Act, including section 4(2) thereof. *See* section 4 of the Act; *see also* Custody Of Investment Company Assets With Futures Commission Merchants And Commodity Clearing Organizations, Investment Company Act Release No. 22389 (Dec. 11, 1996), at n.18 (explaining that UIT portfolios are generally unmanaged).

derivatives transactions. To satisfy this requirement the fund would be required to maintain qualifying coverage assets to cover the fund's mark-to-market obligations under a derivatives transaction, as well as an additional amount, determined in accordance with policies and procedures approved by the fund's board, designed to address potential future losses and resulting payment obligations under the derivatives transaction. The fund's qualifying coverage assets for its derivatives transactions generally would be required to consist of cash and cash equivalents.

Third, except with respect to funds that engage in only a limited amount of derivatives transactions and that do not use certain complex derivatives transactions as defined in the proposed rule, the fund would be required to establish a formalized derivatives risk management program administered by a designated derivatives risk manager. The derivatives risk management program requirement is designed to complement the proposed rule's portfolio limitations and asset segregation requirements applicable to every fund that engages in derivatives transactions by requiring funds subject to the requirement to adopt and implement a derivatives risk management program that addresses the program elements specified in the rule, including the assessment and management of the risks associated with the fund's derivatives transactions. The program would be administered by a derivatives risk manager designated by the fund and approved by the fund's board of directors.

The proposed rule also would permit a fund to enter into financial commitment transactions, which include the trading practices we described in Release 10666 and short sale borrowings, provided that the fund complies with conditions requiring the fund to maintain qualifying coverage assets equal in value to the fund's full obligations under its financial commitment transactions. Because in many cases the timing of the fund's payment obligations may be specified under the terms of a financial commitment transaction or the fund may otherwise have a reasonable expectation regarding the timing of the fund's payment obligations with respect to its financial commitment transactions, a fund relying on the proposed rule would be able to maintain as qualifying coverage assets for a financial commitment transaction assets that are convertible to cash or that generate cash prior to the date on which the fund expects to be required to pay its obligations under the transaction, determined in accordance with policies and procedures approved by the fund's board of directors.[140]

The proposed rule would supersede the guidance we provided in Release 10666, as well as the guidance provided by our staff concerning funds' use of derivatives and financial commitment transactions, which we would rescind if we adopt the proposed rule.[141]

## A. Structure and Scope of Proposed Rule 18f-4

### 1. *Structure of Proposed Rule 18f-4*

Proposed rule 18f-4, as summarized above, is designed both to impose a limit on the leverage a fund relying on the rule may obtain through derivatives transactions and financial commitment transactions, and to require the fund to have qualifying coverage assets to meet its obligations under those transactions, in order to address the undue speculation concern expressed in section 1(b)(7) and the asset sufficiency concern expressed in section 1(b)(8). We discuss in this section of the Release the structure and general approach of proposed rule 18f-4, and discuss the scope of the defined terms "derivatives transactions" and "financial commitment transactions" in section III.A.2 below.

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140 A fund relying on the proposed rule would also be able to maintain as qualifying coverage assets for a financial commitment transaction fund assets that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board of directors.

141 *See infra* section III.I.

As discussed in more detail in the sections that follow, in order to rely on the exemption provided by proposed rule 18f-4 to enter into derivatives transactions, a fund would be required to comply with one of two alternative portfolio limitations and, separately, to maintain qualifying coverage assets designed to enable the fund to meet its obligations under those transactions and to require the fund to manage the risks associated with those transactions. The proposed rule's portfolio limitations are designed primarily to address concerns about a fund's ability to obtain leverage through derivatives transactions, whereas the proposed rule's requirements to maintain qualifying coverage assets are designed primarily to address concerns about a fund's ability to meet its obligations. We believe that this approach for derivatives transactions—providing separate portfolio limitations and asset segregation requirements—would be more effective than an approach focusing only on asset segregation, particularly when it is coupled with a formalized risk management program for funds that engage in more than a limited amount of derivatives transactions or that use certain complex derivatives transactions, as we are proposing today.

We have determined to propose portfolio limitation and risk management requirements for derivatives transactions, in addition to an asset segregation requirement, because as discussed in section II.D above, asset segregation alone in some cases may not provide a sufficient limit on the amount of leverage a fund can obtain through derivatives or sufficient assurances that a fund would have adequate assets to meet its obligations arising under derivatives transactions. The asset segregation approach described in Release 10666 achieved both of these goals—limiting leverage and addressing availability of assets—because that release contemplated that funds would segregate high-quality liquid assets equal in value to the fund's full obligations. A fund that segregated liquid assets equal to the purchase price in a standby commitment agreement, for example, would be limited in its ability to enter into standby commitment agreements because the fund could not incur obligations under those agreements in excess of the fund's available liquid assets; by segregating liquid assets equal to the purchase price of the standby commitment agreement, the fund would have assets available to meet its obligations under the agreement.

Although this approach appears to have addressed the concerns underlying section 18 for the particular instruments described in Release 10666 and is similar to the approach we are proposing today for financial commitment transactions, applying it to derivatives transactions by requiring funds to segregate the kinds of liquid assets we described in Release 10666 equal in value to the full notional amount of each derivative could in some cases require funds to hold more liquid assets than may be necessary to address the investor protection purposes and concerns underlying section 18. The notional amount of a derivatives transaction does not necessarily equal, and often will exceed, the amount of cash or other assets that a fund ultimately would likely be required to pay or deliver under the derivatives transaction. By addressing concerns related to a fund's ability to obtain leverage through derivatives transactions primarily through the proposed portfolio limitations and separately addressing concerns related to a fund's ability to meets its derivatives obligations primarily through the proposed requirements to maintain qualifying coverage assets, the proposed rule is designed to address each concern more directly, while still providing a flexible framework that can be applied by funds to various types of derivatives as they are developed in the marketplace.

These requirements also would be complemented by the proposed rule's risk management requirements, which would require funds that engage in more than a limited amount of derivatives transactions or that use certain complex derivatives transactions, as defined in the proposed rule, to develop formalized risk management programs reasonably designed to assess and manage the risk associated with those transactions based on the fund's own facts and circumstances. This requirement should serve to establish a standardized level of risk management for funds that engage in more than a limited amount of derivatives transactions or that use complex derivatives transactions.

### 2. *Definitions of Derivatives Transactions and Financial Commitment Transactions*

The proposed rule defines the term "derivatives transaction" to mean any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument") under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination.[142] This definition is designed to describe those derivatives transactions that in our view involve the issuance of a senior security, as discussed in section II.B.4 above, because they involve a future payment obligation, that is, an obligation or potential obligation of the fund to make payments or deliver assets to the fund's counterparty.

The proposed rule's definition of "derivatives transaction" incorporates a list of derivatives instruments. We believe this list of derivatives instruments, together with the proposed rule's inclusion of "similar instruments," covers the types of derivatives that funds currently use and that involve fund obligations that implicate section 18, and that this list is sufficiently comprehensive to include derivatives that may be developed in the future.[143] We believe that this approach is preferable to having a more conceptual definition of derivatives

[142] Proposed rule 18f-4(c)(2).

[143] Title VII of the Dodd-Frank Act established a comprehensive framework for the regulation of swaps and security-based swaps. The definitions of these terms under section 1a of the Commodity Exchange Act and section 3(a)(68) of Securities Exchange Act, respectively, are detailed and expansive, and were designed to encompass a wide range of derivatives, including those that could be developed in the future.

transaction, such as an instrument or contract whose value is based upon, or derived from, some other asset or metric, which could be too broad or more difficult to apply, in that it could be understood to include or potentially include instruments or transactions that are sometimes referred to as "derivatives" but which typically would not be expected to implicate section 18.

The proposed rule would define a "financial commitment transaction" as any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement.[144] This definition is designed to describe the trading practices addressed in Release 10666, as well as short sales of securities, for which the staff initially developed the segregated account approach we applied in Release 10666. These transactions involve a conditional or unconditional contractual obligation to pay or deliver assets in the future and thus involve the issuance of a senior security, as discussed in section II.B.4 of this Release.

The proposed rule's definition of financial commitment transactions includes firm and standby commitment agreements, which we addressed in Release 10666,[145] as well as any similar agreement.[146] The rule includes, as a similar agreement, an agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner.[147] We understand that funds often refer to these transactions as "unfunded commitments." In these transactions, as with respect to firm and

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144 Proposed rule 18f-4(c)(4).

145 *See* Release 10666, *supra* note 20, at "Reverse Repurchase Agreements," "Firm Commitment Agreements," and "Standby Commitment Agreements" discussions.

146 Proposed rule 18f-4(c)(4).

147 The definition would not include a transaction under which a fund merely is required to deliver cash or assets as part of regular-way settlement of a securities transaction (rather than a forward-settling transaction or transaction in which settlement is deferred). *Cf.* Release 10666, *supra* note 20, at n.11.

standby commitment agreements, the fund has incurred a conditional or unconditional contractual obligation to pay or deliver assets in the future.

The fund would be exposed to risks as a result of these transactions in that the fund may be required to liquidate other assets of the fund to obtain the cash needed by the fund to satisfy its obligations, and if the fund is unable to meet its obligations, the fund would be subject to default remedies available to its counterparty. For example, if a fund fails to fulfill its commitments to invest in a private fund when called to do so, the fund could be subject to the remedies specified in the limited partnership agreement (or similar document) relating to that private fund, which can include, for example, a forfeiture of some or all of the fund's investment in the private fund.[148]

The rule's definitions of the terms "derivatives transactions" and "financial commitment transactions," discussed above, would specify the types of transactions in which a fund would be permitted to engage under the rule, subject to its conditions. Other senior securities transactions that do not fall within either of these definitions, such as borrowings from a bank by mutual funds or the issuance of other debt securities or preferred equity by closed-end funds or BDCs, could only be done pursuant to the requirements of section 18 (or section 61 in the case of BDCs) or in accordance with some other exemption, rather than proposed rule 18f-4.

We request comment on all aspects of the proposed rule's definitions of the terms "derivatives transaction" and "financial commitment transaction."

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148 *See, e.g.*, Phyllis A. Schwartz & Stephanie R. Breslow, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION (June 2015 ed.), at 2-34 (remedies private equity funds may apply in event of investor default include, among other things, the right to charge high interest on late payments, the right to force a sale of the defaulting investor's interest, the right to continue to charge losses and expenses to defaulting investors while cutting off their interest in future profits, and the right to take any other action permitted at law or in equity).

- Is the definition of "derivatives transaction" sufficiently clear? Are there additional types of derivatives instruments that we should include or any that we should exclude?
- The proposed rule's definition of the term derivatives transactions is designed to describe those derivatives transactions that would involve the issuance of a senior security. Do commenters agree that this is an appropriate approach? Does the rule effectively describe all of the types of derivatives transactions that would involve the issuance of a senior security? The proposed rule's definition of "derivatives transaction" incorporates a list of derivatives instruments, rather than a conceptual definition such as an instrument or contract whose value is based upon, or derived from, some other asset or metric, because we believe that the definition's list of derivatives instruments would more clearly describe the types of derivatives that implicate section 18 than a conceptual definition. Do commenters agree? Why or why not?
- The proposed rule would define a "financial commitment transaction" as any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement. The proposed rule includes, as a similar agreement, an agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the discretion of the private fund's general partner. Do commenters agree with the scope of this definition? Are these terms sufficiently clear? Do commenters agree that it is appropriate to include these transactions?

- Are there additional types of transactions that we should include in the definition of a "financial commitment transaction"? Adding additional transactions to the definition would permit the fund to engage in those transactions by complying with the proposed rule, rather than section 18 or 61. Are there transactions that we should exclude from the definition and for which a fund should be required to comply with the requirements of section 18 (to the extent permitted under section 18), rather than the proposed rule's conditions?
- Our staff has expressed the view that a fund's loan of portfolio securities may involve the issuance of a senior security in light of the fund's obligation to return the collateral upon termination of the loan and has expressed the view that "a mutual fund should not have on loan at any given time securities representing more than one-third of its total asset value."[149] Should we address funds' compliance with section 18 in connection with securities lending by, instead, including a fund's obligation to return securities lending collateral as a financial commitment transaction? Alternatively, should we require a fund to include the obligation to return securities lending collateral for purposes of the proposed rule's exposure limits, as discussed in more detail in section III.B? Or does the current approach under which funds do not have on loan at any given time securities representing more than one-third of the funds' total assets, together with

149 *See*, *e.g.*, The Brinson Funds, SEC Staff No-Action Letter (Nov. 25, 1997), *available at* https://www.sec.gov/divisions/investment/noaction/1997/brinsonfunds112597.pdf (stating that, "[a]s a general matter, securities lending arrangements are regulated under Section 17(f) of the Investment Company Act of 1940, which governs custody arrangements," but that "[t]he staff has stated that a fund's loan of portfolio securities may involve the issuance of a senior security in light of the fund's obligation to return the collateral upon termination of the loan").

other guidance from our staff concerning securities lending by funds, effectively address the senior security implications of securities lending such that we should not address securities lending in the proposed rule? Which approach would be most appropriate and why?

- The proposed rule would permit a fund to enter into a derivatives transaction or financial commitment transaction, notwithstanding the requirements of section 18 or 61 of the Act, if the fund complies with the rule's conditions. Are there other rules or forms we should consider modifying if we adopt the proposed rule? Should we, for example, amend Form N-2 to provide that funds required to file on that form should not include derivatives transactions and financial commitment transactions in the senior securities table? Are there other aspects of our rules and forms that we should consider amending if we were to adopt the proposed rule? If so, which rules and form items and why?
- Should any final rule address, or should we provide guidance concerning, funds' compliance with other aspects of section 18 in connection with funds' use of derivatives transactions or financial commitment transactions? For example, because the proposed rule would permit a fund to enter into derivatives transactions and financial commitment transactions notwithstanding section 18(a)(1) and section 18(f)(1), a fund relying on the proposed rule would not be required to comply with section 18's 300% asset coverage requirement (or section 61's 200% asset coverage requirement) with respect to such transactions.[150]

150 "Asset coverage" of a class of securities representing indebtedness of an issuer generally is defined in section 18(h) of the Investment Company Act as "the ratio which the value of the total

Should we, however, address in any final rule or provide guidance concerning the application of the asset coverage requirements under section 18 or 61 when a fund also enters into senior securities transactions in reliance on section 18 or 61 (such as bank borrowings or, in the case of a closed-end fund or BDC, the issuance of senior debt or preferred stock)? When a fund is calculating asset coverage under section 18(h) for senior securities transactions permitted by section 18 or 61, how should the fund treat its derivatives transactions or financial commitment transactions? When determining the "aggregate amount of senior securities representing indebtedness," how should the fund treat any liabilities and indebtedness associated with the fund's derivatives transactions and financial commitment transactions? Currently, when funds are determining the amount of their liabilities and indebtedness and the amount of their senior securities for purposes of calculations under section 18(h), are funds determining these amounts in accordance with U.S. generally accepted accounting principles? Should a fund also include any liabilities and indebtedness associated with derivatives transactions and financial commitment transactions based on U.S. generally accepted accounting principles? Alternatively, should a fund treat any liabilities and indebtedness for these transactions as "liabilities and indebtedness not represented by senior securities"? What approach would be appropriate and why?

- Is there any guidance we should provide concerning funds' compliance with other provisions of the Investment Company Act in connection with funds' use of

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assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer." *See supra* note 34.

derivatives transactions or financial commitment transactions in reliance on the proposed rule?

### B. Portfolio Limitations for Derivatives Transactions

The proposed rule would require a fund that engages in derivatives transactions in reliance on the rule to comply with one of two alternative portfolio limitations.[151] As explained in more detail below, under the first portfolio limitation (the "exposure-based portfolio limit"), a fund generally would be required to limit its aggregate exposure to 150% of the fund's net assets. A fund's "exposure" for this purpose generally would be calculated as the aggregate notional amount of its derivatives transactions, together with its obligations under financial commitment transactions and other senior securities transactions. The second portfolio limitation (the "risk-based portfolio limit") would permit a fund to obtain exposure in excess of that permitted under the exposure-based portfolio limit where the fund's derivatives transactions, in aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives, evaluated using a test based on value-at-risk ("VaR"). A fund electing the risk-based portfolio limit generally would be required to limit its exposure under derivatives transactions, financial commitment transactions, and other senior securities transactions to 300% of the fund's net assets. As discussed below, these portfolio limitations are designed primarily to address the undue speculation concern expressed in section 1(b)(7) by imposing an overall limit on the amount of exposure to underlying reference assets, and potential leverage, that a fund would be able to obtain through derivatives and other senior securities transactions, while also providing flexibility for a fund to use derivatives for a variety of purposes.[152]

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151 Proposed rule 18f-4(a)(1).

152 The proposed rule's portfolio limitations, although designed to impose a limit on potential leverage, also could help to address concerns about a fund's ability to meet its obligations. As

### *1. Exposure-Based Portfolio Limit*

#### a. Overview

The first portfolio limit would be based on the fund's overall exposure to (i) derivatives transactions, (ii) financial commitment transactions, and (iii) other transactions involving a senior security entered into by the fund pursuant to section 18 or 61 of the Act without regard to the exemption that would be provided by the proposed rule (i.e., senior securities transactions engaged in by a fund in reliance on the requirements of those provisions, rather than in reliance on the exemption that would be provided by the proposed rule).[153] The proposed rule would collectively define these transactions as "senior securities transactions."[154] A fund that relies on the exposure-based portfolio limit would be required to operate so that its aggregate exposure under senior securities transactions, measured immediately after entering into any such transaction, does not exceed 150% of the fund's net assets.[155]

The exposure-based portfolio limit is designed to impose an overall limit on the amount of exposure, and thus the amount of potential leverage, that a fund would be able to obtain through derivatives and other senior securities transactions. We discuss and seek comment

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noted above, the use of derivatives for leveraging purposes can exacerbate the risk that losses on the derivatives, and resulting payment obligations imposed on the fund, can force the fund's adviser to sell the fund's investments to generate liquid assets in order for the fund to meet its obligations. The proposed rule would directly address concerns about a fund's ability to meet its obligations under its derivatives transactions primarily through the proposed rule's requirements to maintain qualifying coverage assets, as discussed below in section III.C.

153 Proposed rule 18f-4(a)(1)(i); proposed rule 18f-4(c)(10) (defining the term "senior securities transaction" to mean any derivatives transaction, financial commitment transaction, or any transaction involving a senior security entered into by the fund pursuant to section 18 or 61 of the Act without regard to the exemption provided by the proposed rule).

154 Proposed rule 18f-4(c)(10).

155 Proposed rule 18f-4(a)(1)(i). As discussed below in section III.B.2, the risk-based portfolio limit also includes an outside limit on a fund's exposure. A fund's exposure for purposes of the risk-based portfolio limit would be calculated as described in this section of the Release, but the exposure limit would be 300% of the fund's net assets rather than 150%. Proposed rule 18f-4(a)(1)(ii).

below on the exposure-based portfolio limit, including the proposed rule's method of calculating a fund's exposure and the rule's limitation of exposure to 150% of the fund's net assets.

b. Calculation of Exposure

The proposed rule would define a fund's "exposure" as the sum of: (i) the aggregate notional amounts of the fund's derivatives transactions, subject to certain adjustments discussed below; (ii) the aggregate obligations of the fund under its financial commitment transactions; and (iii) the aggregate indebtedness (and with respect to any closed-end fund or business development company, involuntary liquidation preference) with respect to any other senior securities transactions entered into by the fund pursuant to section 18 or 61 of the Investment Company Act.[156] We discuss each aspect of this definition below.

i. Exposure for Derivatives Transactions

1) Determination of Notional Amounts

Under the proposed rule, a fund's exposure would include the aggregate notional amounts of its derivatives transactions.[157] The proposed rule would generally define the "notional amount" of a derivatives transaction, subject to certain adjustments required by the rule (discussed below), as the market value of an equivalent position in the underlying reference asset for the derivatives transaction, or the principal amount on which payment obligations under the derivatives transaction are calculated.[158]

We believe that, although derivatives vary widely in terms of structure, asset class, risks and potential uses, for most types of derivatives the notional amount generally serves as a

156 Proposed rule 18f-4(c)(3).

157 Proposed rule 18f-4(c)(3)(i) (defining "exposure").

158 Proposed rule 18f-4(c)(7) (defining "notional amount").

measure of the fund's economic exposure to the underlying reference asset or metric.[159] A total return swap, for example, can provide economic exposure equivalent to a long or short position in the reference asset for the swap. Similarly, a fund can sell or buy a CDS to obtain exposure similar to a long or short position in the credit risk of an issuer of a fixed-income security. We also note that notional amounts are used in numerous other regulatory regimes as a means of determining the scale of the derivatives activities of market participants.[160] We also believe that the definition of notional amount under the proposed rule is consistent with the way the term "notional amount" (or in some cases "notional value") generally is used with respect to derivatives transactions.[161]

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159 Derivatives may be broadly described as instruments or contracts whose value is based upon, or derived from, an underlying reference asset (*see supra* at text preceding note 8). The notional amount generally serves a measure of the underlying economic exposure because it reflects the value of the underlying reference asset for that derivative or the amount of the underlying reference asset on which payment obligations are based.

160 *See, e.g.*, Margin and Capital Requirements for Covered Swap Entities, 80 FR 74839 (Nov. 30, 2015) ("Prudential Regulator Margin and Capital Adopting Release"); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 FR 59898 (Oct. 3, 2014) ("CFTC Margin Proposing Release") (defining "material swaps exposure" by reference to average daily aggregate notional amounts of derivatives transactions). *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)] ("Swap Dealer / Major Swap Participant Release"), at section II.D (discussing use of notional amounts as basis for *de minimis* exemption to swap dealer registration requirements). *See also* CFTC regulations 4.5(c)(ii)(3)(b) and 4.13(a)(3)(ii)(B) (exclusion from definition of commodity pool operator and exemption from commodity pool operator registration requirement, respectively, in respect of certain pools whose commodity interest positions do not exceed 100% of the liquidation value of the pool's portfolio). *See also infra* section IV.E (discussing use of notional amounts under UCITS regulatory regime).

161 For example, "notional value" with respect to futures has been defined as "the underlying value (face value), normally expressed in U.S. dollars, of the financial instrument or commodity specified in a futures or options on futures contract." *See CME Group Glossary*, *available at* http://www.cmegroup.com/education/glossary.html. "'Notional principal' or 'notional amount' of a derivative contract is a hypothetical underlying quantity upon which interest rate or other payment obligations are computed." ISDA Online Product Descriptions and Frequently Asked Questions, *available at* http://www.isda.org/educat/faqs.html#7. The Bank for International Settlements describes "notional amounts outstanding" as "a reference from which contractual payments are determined in derivatives markets." *Guide to the International Financial Statistics,*

Table 1 below sets forth a list of different types of derivatives transactions that are commonly used by funds, together with the method by which we understand a fund, for risk management, reporting or other purposes, typically would calculate the transaction's notional amount. We believe that the proposed rule's definition of notional amount generally would allow a fund to use the calculation methods below to determine the notional amounts of such derivatives transactions (before applying any of the adjustments discussed below) for purposes of calculating the fund's exposure under the proposed rule.[162]

| | |
|---|---|
| **Forwards** | |
| FX forward | Notional contract value of currency leg(s) |
| Forward rate agreement | Notional principal amount |
| **Futures** | |
| Treasury futures | Number of contracts * notional contract size * (futures price * conversion factor + accrued interest) |
| Interest rate futures | Number of contracts * contract unit (*e.g.*, $1,000,000) |
| FX futures | Number of contracts * notional contract size (e.g., 12,500,000 Japanese yen) |
| Equity index futures | Number of contracts * contract unit (*e.g.*, $50 per index point) * futures index level |
| Commodity futures | Number of contracts * contract size (*e.g.*, 1,000 barrels of oil) * futures price |
| Options on futures | Number of contracts * contract size * futures price * underlying delta[163] |

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Bank for International Settlements (July 2009) ("BIS Guide"), *available at* http://www.bis.org/statistics/intfinstatsguide.pdf, at 31. *See also* 2010 ABA Derivatives Report, *supra* note 70, at n.11 (noting that the term "notional amount" is used differently by different people in different contexts, but is used, in the Report, to refer to "the nominal or face amount that is used to calculate payments made on a particular instrument, without regard to whether its obligation under the instrument could be netted against the obligation of another party to pay the fund under the instrument").

162 The methods for determining the notional amounts in the table are similar to those required to be used by UCITS funds that follow the commitment approach (discussed further below in section IV.E. *See* European Securities and Markets Authority (formerly Committee of European Securities Regulators), *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS*, CESR/10-788 (July 28, 2010) ("CESR Global Guidelines"), *available at* http://www.esma.europa.eu/system/files/10_788.pdf.

163 Delta refers to the ratio of change in the value of an option to the change in value of the asset into which the option is convertible. The delta-adjusted notional value of options is needed to have an

| | |
|---|---|
| **Swaps** | |
| Credit default swap | Notional principal amount or market value of underlying reference asset |
| Standard total return swap | Notional principal amount or market value of underlying reference asset |
| Currency swap | Notional principal amount |
| Cross currency interest rate swaps | Notional principal amount |
| **Standardized Options** | |
| Security options | Number of contracts * notional contract size (e.g., 100 shares per option contract) * market value of underlying equity share * underlying delta |
| Currency options | Notional contract value of currency leg(s) * underlying delta |
| Index options | Number of contracts * notional contract size * index level * underlying delta |

Although we believe that the notional amount generally serves as a measure of the fund's exposure to the underlying reference asset or metric,[164] we recognize that a derivative's notional amount does not reflect the way in which the fund uses the derivative and that the notional amount is not a risk measure. An exposure-based test based on notional amounts therefore could be viewed as a relatively blunt measurement in that different derivatives transactions having the same notional amount but different underlying reference assets—for example, an interest rate swap and a credit default swap having the same notional amount—may expose a fund to very different potential investment risks and potential payment obligations.[165] We also recognize that

accurate measurement of the exposure that an option creates to the underlying reference asset. *See, e.g.,* Comment Letter of Morningstar, Inc. on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("Morningstar Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-23.pdf, at 2.

164 *See supra* notes 158-160.

165 While credit default swaps are often considered riskier than typical interest rate or currency derivatives, the staff has observed that even "plain vanilla" interest rate and currency derivatives can lead to significant losses for funds. *See, e.g.,* Katherine Burton, *Swiss Franc Trade Is Said to Wipe Out Everest's Main Fund*, BLOOMBERG (Jan. 18, 2015), *available at* http://www.bloomberg.com/news/articles/2015-01-17/swiss-franc-trade-is-said-to-wipe-out-

there are other approaches to evaluating leverage associated with a fund's derivatives activities, including approaches that disregard or subtract the notional value of hedging transactions from the calculation of a fund's exposure.[166] Leverage can be calculated in numerous ways, however, and the appropriateness of a particular leverage metric may depend on various considerations, such as a fund's strategy and types of investments, and the specific leverage-related risks that are being considered.[167] On balance, we believe that, for purposes of the proposed rule, a notional amount limitation would be a more effective and administrable means of limiting potential leverage from derivatives than a limitation which relies on other leverage measures that may be more difficult to adapt to different types of fund strategies or different uses of derivatives, including types of fund strategies and derivatives that may be developed in the future.

The proposed rule would allow a fund operating under the exposure-based portfolio limit to have exposure of up to 150% of the fund's net assets (*i.e.*, more than the fund's net assets) in recognition of the various ways in which funds may use derivatives. The 150% limit, discussed

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everest-s-main-fundv (noting significant and widespread losses following the Swiss National Bank's decision to decouple the Swiss franc from the euro).

166 *See infra* section III.B.1.d.

167 *See, e.g.*, *An Overview of Leverage*, AIMA Canada (Oct. 2006) ("An Overview of Leverage"), *available at* http://www.aima.org/filemanager/root/site_assets/canada/publications/strategy_paper_-_leverage.pdf (distinguishing between financial, construction and instrument leverage and describing the measurement of leverage using gross market exposure vs. net market exposure). *See also* Off-Balance-Sheet Leverage IMF Working Paper, *supra* note 79 (discussing means of measuring leverage in various types of derivatives and other off-balance-sheet transactions). *See also* Ang, Gorovyy & Inwegen, *supra* note 72 (discussing differences among gross leverage, net leverage and long-only leverage calculations, as applied to long-only, dedicated long-short, general leveraged and dedicated short funds). *See also* Comment Letter of BlackRock, Inc. on Investment Company Reporting Modernization (Aug. 11, 2015) (File No. S7-08-15) ("BlackRock Modernization Comment Letter"), *available at* http://www.sec.gov/comments/s7-08-15/s70815-318.pdf. In the BlackRock Reporting Modernization Comment Letter, the commenter proposed a high-level framework for an approach to measuring economic leverage that could potentially be applied across different types of funds and investment strategies, using comprehensive analysis of multiple different types of risk exposures.

in more detail below, is designed to balance concerns about the limitations of an exposure measurement based on notional amounts with the benefits of using notional amounts, such as the ability of funds to readily determine the notional amounts of their derivatives transactions and the expectation that notional amounts can generally serve as a measure of the size of a fund's exposure to underlying reference assets or metrics, as discussed above.

We believe that, for purposes of the exposure-based portfolio limit, a test that focuses on the notional amounts of funds' derivatives transactions, coupled with an appropriate exposure limit, will better accommodate the broad diversity of registered funds and the ways in which they use derivatives than a test that would require consideration of the manner in which a fund uses derivatives in its portfolio (*e.g.*, for hedging).[168] The rule seeks to achieve a balance between providing flexibility regarding the use of derivatives while limiting the potential risks associated with leverage by, in addition to the exposure limits in the proposed rule, conditioning the rule's exemptive relief on other requirements, such as the asset coverage requirements discussed in section III.C below and, if applicable, the derivatives risk management program requirements discussed in section III.D below, which must be tailored in light of the fund's particular strategy and other characteristics.

Although we believe that an exposure test that focuses on limiting the aggregate notional amounts of funds' derivatives transactions is an appropriate means of limiting leverage, in some cases, the notional amount for a derivatives transaction may not produce a measure of exposure that we believe would be appropriate for purposes of the proposed rule's exposure limitations. The proposed rule therefore includes three provisions relating to the calculation of exposure in

168 *See infra* section III.B.1.d.

respect of certain types of derivatives transactions for which we believe that an adjusted notional amount would better serve as a measure of a fund's investment exposure for purposes of the rule.

First, for derivatives that provide a return based on the leveraged performance of an underlying reference asset, the rule would require the notional amount to be multiplied by the applicable leverage factor.[169] Thus, for example, the rule would require a total return swap that has a notional amount of $1 million and provides a return equal to three times the performance of an equity index to be treated as having a notional amount of $3 million. Absent this provision, a fund could enter into a derivative with a stated notional amount that did not reflect the magnitude of the fund's leveraged investment exposure under the derivative.[170] Such a transaction, if not measured based on the leverage inherent in the derivative instrument, could otherwise provide a means of structuring transactions to avoid the proposed rule's exposure limitations.

Second, the proposed rule includes a "look-through" for calculating the notional amount in respect of derivatives transactions for which the underlying reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity.[171] We understand that some funds, including funds that engage in managed futures or

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169 Proposed rule 18f-4(c)(7)(iii)(A).

170 A similar requirement applies to the determination of *de minimis* thresholds for swap dealer and security-based swap dealer registration. *See* Swap Dealer / Major Swap Participant Release, *supra* note 160, at n.427 and accompanying text (stating that, for purposes of the *de minimis* threshold for registration of swap dealers, "notional standards will be based on 'effective notional' amounts when the stated notional amount is leveraged or enhanced by the structure of the swap or security-based swap").

171 Proposed rule 18f-4(c)(7)(iii)(B). The managed account or interests in the entity may be owned by the fund's counterparty (*e.g.*, a swap dealer), which hedges its obligations under the derivative through its ownership of such account or interests. In some cases, the derivative contract may describe the reference asset as an index comprising the performance of transactions "notionally" entered into by the trading manager, or the "notional" performance of an index comprising the

foreign currency strategies, obtain their investment exposures for such strategies by entering into a swap that references the performance of a managed account or entity, which in turn is managed on a discretionary basis by a third-party trading manager (such as a commodity trading advisor). Such swaps can be used by a fund to obtain a return that is economically nearly identical to a direct investment by the fund in the derivatives traded by the third-party trading manager for the managed account or entity.[172] Absent a look-through to the derivatives transactions of the underlying reference vehicle, such structures could be used to avoid the exposure limitations that would be applicable under the proposed rule if the fund directly owned the managed account or securities issued by the reference entity.[173] Accordingly, for such derivatives transactions, the rule would require a fund to calculate the notional amount by reference to the fund's *pro rata* portion of the notional amounts of the derivatives transactions of the underlying reference vehicle, which in turn must be calculated in a manner consistent with the requirements of the proposed rule.[174] The provision thus would apply to transactions such as swaps on pooled

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managed account or entity together with cash and/or other positions. The proposed rule's "look-through" for calculating notional amounts thus applies to derivatives transactions for which the underlying reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, as well as an index that reflects the performance of such a managed account or entity. *Id.*

172 Some funds appear to use these swaps in such a way that nearly all of the fund's investment exposure is indirectly attributable to the derivatives traded by the third-party manager for the underlying managed account or entity, while the fund's direct investments (other than the swap) are limited to cash and cash equivalents.

173 For example, a fund might enter into a swap having a notional value of $10, corresponding to the value of an equity security issued by a trading entity. The fund's counterparty could then invest $10 in the trading entity, which in turn could use these funds as margin or collateral for leveraged futures or currency forward transactions having a much larger aggregate notional amount, e.g., $100. Proposed rule 18f-4(c)(7)(iii)(B) would require the fund to treat the swap in this example as having a notional amount of $100 rather than $10.

174 Thus, for example, if a fund enters into a swap on the performance of a trading entity that, in turn, enters into a swap that provides a return based on the leveraged performance of an equity index, the notional amount of the equity index would need to be multiplied by the applicable leverage

investment vehicles that are formed or operated primarily for the purpose of investing in or trading derivatives transactions, which could include hedge funds, managed futures funds and leveraged ETFs, in order to prevent a fund from entering into a leveraged swap on the performance of shares or other interests issued by such vehicles and thereby indirectly obtain leverage in excess of what the rule would permit a fund to obtain directly.

Third, the proposed rule contains specific provisions for calculating the notional amount for certain defined complex derivatives transactions. As explained further below, the proposed rule includes these provisions because, for complex derivatives transactions, the notional amounts of such transactions determined without regard to these specific provisions may not serve as an appropriate measure of the underlying market exposure obtained by a fund.

The proposed rule would define a complex derivatives transaction as any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise: (i) is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction; or (ii) is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.[175] We address each of these provisions below.

The first type of complex derivatives transaction is a derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise is dependent on the value of the underlying reference asset at multiple points in time during the term of the

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factor, consistent with the method set forth in proposed rule 18f-4(c)(7)(iii)(A), for purposes of calculating the fund's *pro rata* share of the notional amounts of the trading entity's derivatives transactions in accordance with proposed rule 18f-4(c)(7)(iii)(B).

175 *See* proposed rule 18f-4(c)(1) (defining "complex derivatives transaction") and proposed rule 18f-4(c)(7)(iii)(C) (describing the method for calculating the notional amount for a complex derivatives transaction for purposes of the proposed rule).

transaction.[176] This provision is designed to capture derivatives whose payouts are path dependent, *i.e.,* the payouts depend on the path taken by the value of the underlying asset during the term of the transaction. Many types of non-standard options exhibit path dependency.[177] An example of a path dependent derivative would be a barrier option. Barrier options (also known as knock-in or knock-out options) have a payoff that is contingent on whether the price of the underlying asset reaches some specified level prior to expiration.[178] Another example would be an Asian option, which has a payoff that depends on the average value of the underlying asset from inception until expiration.[179] By contrast, a standard put or call option having a single strike price would not be a complex derivatives transaction under this provision of the definition, because the payout of a standard put or call option depends on the value of the reference asset only upon exercise, i.e., at a single point rather than multiple points in time during the term of the transaction.

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176 *See* proposed rule 18f-4(c)(1)(i).

177 *See* Paul Wilmott, PAUL WILMOTT ON QUANTITATIVE FINANCE (2nd ed. 2006) ("Wilmott"), at 371 (options that "have payoffs that depend on the path taken by the underlying asset, and not just the asset's value at expiration… are called path dependent." *See also* CESR Global Guidelines, *supra* note 162, at 12 (noting that "[c]ertain derivative instruments exhibit risk characteristics that mean the standard conversion approach is not appropriate as it does not adequately capture the inherent risks relating to this type of product. Some derivatives, for example, may exhibit path-dependency, such features emphasising the need to have both robust models for risk management and pricing purposes, but also to reflect their complexity in the commitment calculation methodology").

178 Wilmott, *supra* note 177, at 371.

179 *Id.* A third example would be an option with a lookback feature, which has a payoff that depends on whether a maximum or minimum value of the underlying asset occurred during some period prior to expiration. A lookback call option, for example, pays at settlement the difference between the final asset price and the lowest price of the asset observed during the term of the option. Because the payoff is contingent on two prices – the final asset price and the lowest observed price – a lookback call option would be a complex derivatives transaction. *See id.* at 383; *see also* Robert Whaley, DERIVATIVES: MARKETS, VALUATION, AND RISK MEASUREMENT (2006) ("Whaley"), at 291.

The second type of complex derivatives transaction is a derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.[180] Most types of derivatives traded on an exchange or with standardized terms (other than exchange-traded or standardized options) involve payment amounts between the parties that change on a dollar-for-dollar basis tracking changes in the value of the underlying reference asset. We refer to these calculations under relatively standardized terms as involving a linear function of the value of the underlying reference assets. An example of a "non-linear" derivatives transaction that would be a complex derivatives transaction under this provision of the definition would be a variance swap. A variance swap is an instrument that allows investors to profit from the difference between the current implied volatility and future realized volatility of an asset; however, the payoff for a variance swap is a function of the difference between current implied *variance* and future realized *variance* of the asset.[181] Because variance is the square of volatility, the payment obligations under a variance swap are non-linear.[182]

This second provision of the definition of complex derivatives transaction includes a carve-out that would exclude derivatives for which payout upon settlement date, maturity or exercise is non-linear due to optionality arising from a single strike price. This exception is designed to exclude standard put or call options from the complex derivatives transaction

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180 *See* proposed rule 18f-4(c)(1)(ii).

181 *See*, *e.g.*, Sebastien Bossu, *Introduction to Variance Swaps*, WILMOTT MAGAZINE, *available at* http://www.wilmott.com/pdfs/111116_bossu.pdf, at 50-51.

182 *See*, *e.g.*, Peter Allen, Stephen Eincomb & Nicolas Granger, *Variance Swaps*, JPMorgan Investment Strategies: No. 28 (Nov. 17, 2006), at 11 (noting that "variance swap strikes are quoted in terms of volatility, not variance; but pay out based on the difference between the level of variance implied by the strike (in fact the strike squared) and the subsequent realised variance").

definition, which would otherwise be captured because their payout is non-linear. For example, the payout for a standard cash-settled written call option is either equal to zero (if the price of the underlying asset at maturity is less than or equal to the strike price) or equal to the difference between the value of the underlying asset and the strike price (if the price of the underlying asset at maturity is greater than the strike price), and is therefore non-linear. We believe that it is unnecessary to treat standard put and call options as complex derivatives transactions because the method for determining the notional amount for such derivatives, *i.e.*, the market value of the underlying asset multiplied by its delta, serves as an appropriate measure of a fund's exposure for purposes of the rule because it generally would result in a notional amount that reflects the market value of an equivalent position in the underlying reference asset for the derivatives transaction.[183]

The proposed rule would include a special provision for calculating the notional amount of complex derivatives transactions for purposes of determining a fund's exposure.[184] This provision is designed to address two primary concerns. The first is that the notional amount for some complex derivatives, if determined without regard to this provision, may not appropriately reflect the fund's underlying market exposure for purposes of the portfolio limitation. For example, the notional amount of a variance swap is typically expressed in terms of "vega notional," *i.e.*, a measure of volatility. This vega notional amount is used to calculate the payout for a variance swap, but it does not correspond to the market value or principal amount of a

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183 *See, e.g.*, Mark Rubinstein & Hayne E. Leland, *Replicating Options with Positions in Stock and Cash*, 51 FINANCIAL ANALYSTS J. 113 (Jan./Feb. 1995) (demonstrating how a long or short position in a standard put or call can be replicated by holding a long or short position in a number of shares of the underlying stock corresponding to the option's delta, which would have a value equal to the option delta multiplied by the underlying stock price).

184 Proposed rule 18f-4(c)(7)(iii)(C).

reference asset that can appropriately be compared against a fund's net assets for purposes of the exposure-based portfolio limit.[185] A second concern is that complex derivatives can have market risks that are difficult to estimate due to the presence of multiple forms of optionality or other non-linearities, which similarly may not be adequately reflected in a notional amount calculated without separately considering each of the risks as with the special provision in the proposed rule for complex derivatives transactions.[186]

The proposed rule seeks to address these concerns by specifying an alternative approach for determining the notional amount for a complex derivatives transaction. Under this approach, the notional amount of a complex derivatives transaction would be equal to the aggregate notional amount(s) of other derivatives instruments, excluding other complex derivatives transactions (together, "substituted instruments"), reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction at the time the fund enters into the transaction.[187] This approach is designed to address the difficulty of determining the notional

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185 For example, a fund that invests in a total return swap on an equity index having a notional amount of $100 can be said to have exposure similar to a $100 investment in the index components. By contrast, it is not possible to draw a comparison between the notional amount of a variance swap on the same equity index and a direct investment in the index components.

186 The UCITS Commitment Approach Guidelines express a similar concern. *See* CESR Global Guidelines, *supra* note 162, at 12 (noting that a common feature of non-standard derivatives is "the existence of a highly volatile delta which could, for example, result in significant losses" and therefore "many of these instruments will need to be assessed on a case by case basis").

187 Proposed rule 18f-4(c)(7)(iii)(C). As discussed in section III.F below, the proposed rule would require the fund to maintain a written record demonstrating that immediately after the fund entered into any senior securities transaction, the fund complied with the portfolio limitation applicable to the fund immediately after entering into the senior securities transaction, including the fund's aggregate exposure, among other things. Where the fund enters into a complex derivatives transaction, the fund, in documenting its exposure immediately after entering into the transaction, would be required to document the way it determined the notional amount of the complex derivatives transaction, that is, the notional amount(s) of substituted instruments that could reasonably be expected to offset substantially all of the market risk of the complex derivatives transaction at the time the fund entered into the transaction.

amount for some complex derivatives transactions and the concern that the reference asset or metric may not by itself be an appropriate measure of the underlying market exposure, by substituting, in effect, the notional amounts of non-complex instruments that mirror the market risk of the complex derivatives transaction.[188] For example, a barrier option in some cases can be hedged using standard put and call options (which would not be complex derivatives transactions provided that they had a single strike price).[189] In that case, a fund could use the aggregate notional amount of such puts and calls (i.e., the strike price multiplied by the delta) as the notional amount for purposes of determining the fund's exposure.[190]

2) Netting of Certain Derivatives Transactions

The proposed rule includes a netting provision that would permit a fund, in determining its aggregate notional exposure, to net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms.[191] This limited netting provision is designed to apply to those types of derivatives transactions for which, due to regulation, transaction structure or market practice, a fund

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188 The UCITS Global Exposure Guidelines similarly call for derivatives with complex structures to be "broken down into component parts" so that "the effect of layers of derivative exposures [can] be adequately captured." CESR Global Guidelines, *supra* note 162, at 12. *See also* Wilmott, *supra* note 177, at 506 (stating, with regard to "exotic" derivatives, that "[i]f a contract can be decomposed into simpler, vanilla products, then that's what you should do for pricing and hedging").

189 *See generally* Wilmott, *supra* note 177, at 969-987 (describing methods for hedging barrier options using "vanilla" exchange-traded options); *see also* Peter Carr, Katrina Ellis & Vishal Gupta, *Static Hedging of Exotic Options*, 53 J. OF FIN. 1165, 1169 (June 1998) (describing methods for hedging barrier options, lookback options and other "exotic" options using standard put and call options).

190 The proposed rule would not require a fund to actually invest in substituted instruments instead of investing in the complex derivatives transaction, but rather would require a fund to use the notional amounts of substituted instruments in order to determine its exposure for purposes of the proposed rule's portfolio limitations.

191 Proposed rule 18f-4(c)(3)(i).

typically would use an offsetting transaction to effectively settle all or a portion of the transaction prior to expiration or maturity, such as certain futures and forward transactions. It would also apply to situations in which a fund seeks to reduce or eliminate its economic exposure under a derivatives transaction without terminating the transaction. This may be the case, for example, if terminating the transaction would be more costly to the fund (for example, because the fund would need to pay an early termination fee) than entering into an offsetting transaction with another counterparty, or if terminating the transaction would cause the fund to realize gain or loss for tax purposes earlier than would be required if the fund entered into an offsetting transaction. The netting provision under the proposed rule accordingly would permit a fund to exclude from its aggregate exposure the notional amounts associated with transactions that are entered into by the fund to eliminate the fund's exposure under another transaction through a directly offsetting transaction as described under the proposed rule.[192]

With respect to transactions that are directly offsetting but involve different counterparties, we note that, although a fund would remain exposed to counterparty risk, such offsetting transactions could reasonably be expected to eliminate market risk associated with the offsetting transactions if they are the same type of instrument and have the same underlying reference asset, maturity and other material terms. Accordingly, we believe that such transactions are an appropriate means to eliminate or reduce market exposure under derivatives transactions even if entered into with different counterparties for purposes of the rule's exposure limits, which are designed to limit the extent of the fund's exposure.

192 The netting provision under the proposed rule is not designed to enable a fund generally to disregard or subtract from the calculation of a fund's exposure the notional amount of transactions that the fund deems to be hedging or risk mitigating. *See* section III.B.1.d. The netting provision applies only to directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms.

By contrast, the netting provision would not apply to transactions that may have certain offsetting risk characteristics but do not have the same underlying reference asset, maturity and other material terms or involve different types of derivatives instruments. For example, while a long position in a March 2016 copper futures contract could directly offset a short position in the same March 2016 copper futures contract, it would not directly offset a short position with respect to copper options or April 2016 copper futures. Similarly, a purchased option would not offset a written option that has a different maturity date or a different underlying reference asset. With respect to transactions that do not have the same underlying reference asset, maturity and other material terms, we are concerned that these transactions may not merely have the effect of eliminating or reducing market exposure. For example, they might instead be used as paired "collar" or "spread" investment positions that could raise potential risks associated with strategies that seek to capture small changes in the value of such paired investments. We also believe that it would be difficult to develop standards for determining circumstances under which such transactions should be considered to have eliminated the market and leverage risks associated with the positions in a manner that would appropriately limit the potential for funds to incur excessive leverage or unduly speculative exposures.

#### ii. Exposure for Financial Commitment Transactions and Other Senior Securities

A fund also would be required to include, in calculating its exposure: (i) the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under any financial commitment transactions ("financial commitment obligations");[193] and (ii) the aggregate indebtedness (and with respect to any closed-end fund or business development

[193] Proposed rule 18f-4(c)(3)(ii).

company, involuntary liquidation preference) with respect to any other senior securities transaction entered into by the fund pursuant to section 18 or 61 of the Act without regard to the exemption provided by the proposed rule.[194] As explained below, these aspects of the exposure calculation are designed to require a fund that enters into derivatives transactions in reliance on the exemption provided by the proposed rule to include in its aggregate exposure all of the fund's indebtedness or exposure obtained through senior securities transactions.

Under the proposed rule, a fund would be required to include its exposure under these types of transactions in determining its compliance with the 150% exposure limit because, although we have determined to propose an exemption from the requirements of section 18 and 61 to permit funds to enter into derivatives and financial commitment transactions, we believe that, in order to address the investor protection purposes and concerns underlying section 18, a fund relying on the exemption should be subject to an overall limit on leverage. As discussed in more detail below in section III.B.1.b.2, we have proposed to set this limit at 150% of net assets (and at 300% of net assets for a fund operating under the risk-based portfolio limit) because we believe that is an appropriate limit on a fund's exposure from derivatives, financial commitment transactions, and other senior securities transactions.

If the proposed rule did not require exposure from all senior securities transactions to be included for purposes of calculating a fund's exposure, a fund relying on the exemption the rule

[194] Proposed rule 18f-4(c)(3)(iii). This could include, for example, bank borrowings and, for a closed-end fund or BDC, the issuance of debt or preferred shares. Section 18(g) of the Act excludes from the definition of senior security "any such promissory note or other evidence of indebtedness in any case where such a loan is for temporary purposes only and in an amount not exceeding 5 per centum of the value of the total assets of the issuer at the time when the loan is made." Such borrowings that meet the requirements of the exclusion for temporary borrowings under section 18(g) would not be considered senior securities transactions for purposes of the proposed rule, and thus would not be included in the proposed rule's exposure calculations.

would provide could obtain aggregate exposure in excess of the proposed rule's exposure limits. For example, a fund having net assets of $100 that complies with the exposure-based portfolio limit might otherwise, in theory, obtain $150 of leveraged exposure through derivatives plus additional leverage in the form of financial commitment transactions and other borrowings. We have determined to address this concern by requiring a fund to include exposure from all senior securities transactions, but subject to a 150% limit, rather than proposing a substantially lower limit that might be appropriate if the exposure calculation were based solely on derivatives exposure.

We request comment on all aspects of the exposure determinations for derivatives transactions.

- Is the proposed rule's use of notional amounts as the basis for calculating a fund's exposure under a derivatives transaction appropriate? Does the notional amount of a derivatives transaction generally serve as an appropriate means of measuring a fund's exposure to the applicable reference asset or metric? Are there particular types of derivatives transactions or reference assets for which the notional amount would or would not be effective in this regard? For such derivatives, what alternative measures might be used and why would they be more appropriate? Would such alternative measures be easier for funds and compliance staff to administer?
- For derivatives transactions that provide a return based on the leveraged performance of an underlying reference asset, the rule would require the notional amount to be multiplied by the applicable leverage factor. Do commenters agree that this is appropriate?
- The proposed rule includes a "look-through" for calculating the notional amount in respect of derivatives transactions for which the underlying reference asset is a managed

account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity. Do commenters agree that this is appropriate? Is this requirement sufficiently clear? Would the look-through provision capture swaps or other derivatives on reference entities or assets that should not be covered by this provision? Why or why not? Would a fund that uses these types of transactions be able to obtain information from its counterparty regarding the fund's *pro rata* portion of the notional amounts of the derivatives transactions of the underlying reference vehicle, in order for the fund to be able to determine its compliance with the exposure limitations under the proposed rule? Why or why not? Would funds that currently use these transactions find it necessary to amend their existing contracts with counterparties in order to obtain such information? Are there other ways we should consider addressing the concern, noted above, that absent a look-through to the derivatives transactions of the underlying reference vehicle, such structures could be used to avoid the exposure limitations that would be applicable under the proposed rule if the fund directly owned the managed account or securities issued by the reference entity? We understand that the accounts or entities that serve as the reference assets for these transactions generally are actively managed, such that the notional amounts of the derivatives transactions of such accounts or entities may change frequently. In light of this, and given the concern that the look-through requirement seeks to address, should the proposed rule also require a fund to determine its compliance with the exposure limitations of the rule whenever the notional amount of the fund's *pro rata* portion of the notional amounts of the derivatives transactions of the underlying reference vehicle changes? Why or why not?

- To what extent do funds enter into derivatives transactions for which pooled investment vehicles (e.g., hedge funds or other registered funds, such as ETFs and mutual funds) serve as reference assets? For what purposes do funds enter into such derivatives transactions? To what extent do the referenced pooled investment vehicles themselves use derivatives, such that funds could use derivatives for which a pooled investment vehicle serves as a reference asset in order to obtain leverage in excess of the limits provided under the proposed rule? Would a fund that uses these types of derivatives transactions be able to obtain information from the underlying pooled investment vehicle regarding the notional amounts of the underlying pooled investment vehicle's derivatives transactions, in order for the fund to be able to determine its compliance with the exposure limitations under the proposed rule's look-through requirement? Why or why not? Should we specify standards for determining whether a pooled investment vehicle should be considered formed or operated primarily for the purpose of investing in or trading derivatives? What would be an appropriate standard?
- Do commenters agree with the proposed definition of "complex derivatives transaction"? Are there derivatives transactions that may be considered complex derivatives transactions under the proposed definition but should not be, or vice versa? Does the method for calculating exposure for complex derivatives transactions create the potential for transactions to be structured to avoid this aspect of the rule? If so, how might that be avoided (e.g., by modifying the definition or through other means)?
- The proposed rule would require a fund to calculate the notional amount for a complex derivatives transaction by using the notional amount(s) of one or more instruments, excluding other complex derivatives transactions (collectively, "substituted instruments,"

as noted above), that could reasonably be expected to offset substantially all of the market risk of the complex derivatives transaction Do commenters agree with this method for calculating exposure in respect of complex derivatives transactions? Should the rule specify a particular test or tests that a fund could elect to use, or be required to use, in order to establish that the notional amount it uses for a complex derivatives transaction meets this requirement? For example, should the rule provide that a group of substituted instruments will be deemed to reasonably be expected to offset substantially all of the market risk associated with a complex derivatives transaction if the fund can demonstrate, using a VaR model that meets the requirements of paragraph (c)(11)(ii)[195] of the proposed rule, that the combined VaR of the substituted instruments and the complex derivatives transaction is less than 1%, or some other percentage, of the VaR of the complex derivatives transaction by itself (in other words, if a complex derivative had a VaR of $100 but the combined VaR of the complex derivatives transaction and the substituted instruments were less than $1, the substituted instruments would be deemed to have offset substantially all of the market risk associated with the complex derivative)? What other approaches might a fund use?

- Are there complex derivatives transactions for which substantially all of the market risk cannot be offset using substituted instruments, and for which the fund would not be able to determine a notional amount under the proposed rule? What kinds of transactions, and do funds use such transactions? To the extent there are complex derivatives transactions for which a fund would not be able to offset substantially all of the market risks using substituted instruments, would the fund's inability to offset substantially all of the market

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195 *See infra* section III.B.2.b.

risks using substituted instruments indicate that the fund would be unable effectively to determine the degree of market risk inherent in the transaction? Would such transactions pose greater risks for funds because, for example, they are less liquid or more likely to expose funds to potential losses that may be difficult to quantify?

- We note that, under the CESR Global Guidelines, if the exposure for a non-standard derivative cannot be determined based on the market value of an equivalent position in underlying reference assets and such derivatives represent more than a negligible portion of the UCITS portfolio, a UCITS fund cannot use the commitment approach.[196] Should the proposed rule similarly restrict a fund's ability to use these kinds of transactions? Should the proposed rule prohibit a fund from using such transactions? If not, should the proposed rule provide an alternative method for determining the notional amount for a complex derivative for which substantially all of the market risk cannot be offset using substituted instruments? What method?
- Is the netting provision for calculating a fund's exposure appropriate? Are there other circumstances under which netting should be permitted? Are there transactions that the provision would permit to be netted but should not be?
- Are there other adjustments pertaining to the use of notional amounts for purposes of determining a fund's exposure appropriate that we should consider, either with respect to certain types of derivatives transactions or in general? For example, we understand that the notional amounts for Euribor and Eurodollar futures are often referenced by market participants by dividing the amount of the contract by four in order to reflect the three-month length of the interest rate transaction, and our staff took this approach in

196 *See* CESR Global Guidelines, *supra* note 162, at 7, 12.

evaluating funds' notional exposures, as discussed in the DERA White Paper. For these very short-term derivatives transactions, calculating notional amounts without dividing by four would reflect a notional amount that could be viewed as overstating the magnitude of the fund's investment exposure. Should the proposed rule permit or require this practice? Why or why not? Would a derivative's notional amount adjusted in this way serve as a better measure of the fund's exposure than the derivative's unadjusted notional amount? Are there other futures contracts (or other standardized derivatives) for which an analogous adjustment should be permitted? Why or why not?

- Should we consider permitting or requiring that the notional amounts for interest rate futures and swaps be adjusted so that they are calculated in terms of 10-year bond equivalents or make other duration adjustments to reflect the average duration of a fund that invests primarily in debt securities? Would this result in a better assessment of a fund's exposure to interest rate risk? Why or why not?
- Could derivatives transactions be restructured so that they provide a level of exposure to an underlying reference asset or metric that exceeds the notional amount as defined in our proposed rule, while nonetheless complying with the rule's conditions? If so, what modifications should we make to address this?
- Should the calculation of exposure be broadened to include not only derivatives that involve the issuance of senior securities (because they involve a payment obligation) but also derivatives that would not generally be considered to involve senior securities, such as purchased options, structured notes, or other derivatives that provide economic leverage, given that such instruments can increase the volatility of a fund's portfolio and

thus cause an investment in a fund to be more speculative than if the fund's portfolio did not include such instruments?

- Should the proposed rule require a fund to include the exposure associated with certain so-called "basket option" transactions, which are derivatives instruments that may nominally be documented in the form of an option contract but are economically similar to a swap transaction? We understand that these types of basket option transactions often involve a deposit by an investor of a cash "premium" that functions as collateral for the transaction, and all or a portion of which may be returned to the investor depending on the performance of the basket of reference assets.[197] Should we require a fund to include the exposure associated with these transactions because they operate in a manner similar to swap transactions and differ significantly from the typical purchased option contract with a non-refundable premium payment?[198]
- Do commenters agree that it is appropriate to include exposure associated with a fund's financial commitment transactions and other senior securities transactions in the calculation of the fund's exposure for purposes of the 150% exposure limit in the exposure-based portfolio limit (and the 300% limit under the risk-based portfolio limit),

197 *See Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits,* Report of the Permanent Subcommittee on Investigations, United States Senate (July 22, 2014), at p. 79 ("The hedge funds told the Subcommittee that, rather than tax, a major motivating factor behind their participation in the basket options was the opportunity to obtain high levels of leverage, beyond the federal leverage limit of 2:1 normally applicable to [regulatory margin requirements for] brokerage accounts, an assertion supported by the banks.").

198 These basket options, which typically have a strike price that is in-the-money at inception (reflecting the value of the initial premium payment) together with provisions that require the delivery of additional premium amounts or termination if the reference basket declines in value, thus function in a manner very similar to a swap that requires the delivery of collateral at inception and can be terminated if additional collateral is not delivered if the reference basket under the swap declines in value.

as proposed, so that the exposure limit would include the fund's exposure from all senior securities transactions? Should we, instead, include only exposure associated with a fund's derivatives transactions but reduce the exposure limits so that a fund that would rely on the exemption provided by the proposed rule would be subject to a limit on leverage or potential leverage from all senior securities transactions? If we were to take this approach should we, for example, reduce the exposure limits to 50% in the case of the exposure-based portfolio limit and 100% in the case of the risk-based limit?

c. 150% Exposure Limit

As noted above, a fund that elects to comply with the exposure-based portfolio limit under the proposed rule would be required to limit its derivatives transactions, financial commitment transactions and obligations under other senior securities transactions, such that the fund's aggregate exposure under these transactions, immediately after entering into any senior securities transaction, does not exceed 150% of the fund's net assets.[199]

The exposure-based portfolio limit is designed to impose a limit on the amount of leverage a fund may obtain through senior securities transactions while also providing flexibility for funds to use derivatives transactions for a variety of purposes.[200] As discussed above, and as noted by several commenters to the Concept Release, many derivatives transactions result in investment exposures that are economically similar to direct investments in the underlying reference assets financed through borrowings. According to one commenter, for example, an equity total return swap "produces an exposure and economic return substantially equal to the exposure and economic return a fund could achieve by borrowing money from the counterparty

[199] Proposed rule 18f-4(a)(1)(i).

[200] The proposed rule's portfolio limitations, although designed to impose a limit on leverage, also could help to address concerns about a fund's ability to meet its obligations. *See supra* note 152.

in order to purchase the equities that are reference assets."[201] Because derivatives transactions can readily be used for leveraging purposes, we believe that limiting the aggregate notional amount of a fund's derivatives transactions (subject to certain adjustments under the proposed rule) can appropriately serve to limit the amount of leverage the fund could potentially obtain through such transactions. We also believe that an exposure limitation based, in part, on the aggregate notional amount of a fund's derivatives transactions should be set at an appropriate amount that reflects the various ways in which funds may use derivatives, while also imposing a limit on the amount of leverage a fund may obtain through derivatives transactions (and other senior securities transactions), consistent with the investor protection purposes and concerns underlying section 18.

In determining to propose a 150% exposure limitation, we evaluated a range of considerations. First, we considered the extent to which a fund could borrow in compliance with the requirements of section 18. As discussed in more detail in section II, funds generally can incur indebtedness through senior securities under section 18 subject to the asset coverage requirement specified in that section, which effectively permits a fund to incur indebtedness of

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201 *See* Comment Letter of BlackRock on the FSOC Request for Comment (Mar. 25, 2015) (FSOC 2014-0001) ("BlackRock FSOC Comment Letter"), *available at* http://www.blackrock.com/corporate/en-us/literature/publication/fsoc-request-for-comment-asset-management-032515.pdf, at 8 ("[D]erivatives can be used to lever a portfolio, in essence creating additional economic exposure.") *See also* BlackRock Concept Release Comment Letter, at 4 (noting that in circumstances where a derivative is effectively substituting for one or more 'long' physical security positions, "the full notional amount of the reference asset is at risk to the same extent as the principal amount of a physical holding, and any difference between the amount invested by the fund and the notional amount of the derivative is equivalent to a 'borrowing'."). *See also* Keen Concept Release Comment Letter, at 8 (noting that, except with respect to hedging transactions, "the notional amount of swaps should be treated as creating investment leverage and subject to any asset coverage requirement the Commission imposes on the issuance of senior securities by investment companies"). *See also* Morningstar Concept Release Comment Letter, at 2 (noting that, by using futures, a fund may only need $5 of initial margin to obtain $100 worth of notional exposure to the S&P 500 and that such position may represent "effectively a 100% equity investment").

up to 50% of the fund's net assets.[202] For example, a mutual fund with $100 in assets and with no liabilities or senior securities outstanding could borrow an additional $50 from a bank. We therefore considered whether it would be appropriate to propose a 50% exposure limitation under the proposed rule, in order to limit a fund's derivatives exposure to the same extent as section 18 limits a fund's ability to borrow from a bank (or issue other senior securities representing indebtedness subject to section 18's 300% asset coverage requirement).[203] We also considered an exposure limitation of 100% of net assets, which would more closely track the level of exposure suggested by Release 10666 for the trading practices described in that release.[204]

We have not proposed these lower exposure limits of 50% or 100% of net assets primarily due to our consideration of the point made by numerous commenters that funds use derivatives for a range of purposes that may not, or may not be expected to, result in additional leverage for the fund.[205] Commenters have noted that many funds use derivatives for hedging or risk-mitigation, or choose to use derivatives for reasons other than specifically to obtain

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202 *See supra* note 34.

203 We note that, at this level of exposure limitation, the corresponding limitation on BDCs could be set at 100% of net assets to reflect the increased borrowing capacity that Congress has permitted BDCs to obtain under section 61 of the Act.

204 One of the commenters to the Concept Release indicated that this level of exposure would be the effective limit under Release 10666 "[a]s originally conceived by the Commission," explaining that, "[a]s a practical matter, requiring the segregation of assets but not limiting the permitted segregation to cash equivalents effectively permitted funds to incur investment leverage up to a theoretical limit equal to 100% of a fund's net assets." *See* Ropes & Gray Concept Release Comment Letter.

205 *See, e.g., infra* note 248 and accompanying text. *See also* BlackRock FSOC Comment Letter, at 8 (noting that in certain cases "derivatives are used to hedge (mitigate) risks and thus do not result in the creation of leverage and, in fact may specifically reduce economic leverage.); BlackRock Concept Release Comment Letter, at 4-5 (noting that "in the context of an overall portfolio, a derivative holding may increase overall leverage, decrease overall leverage or have no effect on overall leverage") (internal footnotes omitted).

leverage.[206] Thus, although a lower exposure limit, like the 100% limitation suggested by Release 10666, may be appropriate for the trading practices described in that release, that exposure limit may not be appropriate when applied to derivatives' notional exposure. Such a lower exposure limit, as well as the 50% limitation we considered, could limit a fund's ability to use derivatives transactions for purposes other than leveraging the fund's portfolio that may be beneficial to the fund and its investors.[207]

As described in greater detail below in section III.B.1.d, we considered whether to reflect the different ways in which funds might use derivatives by excluding from that calculation any exposure associated with derivatives transactions that may arguably be used to hedge or cover other transactions. This would be similar to the guidelines that apply to UCITS funds, which generally are subject to an exposure limit of 100% of net assets, but are not required to include exposure relating to certain hedging transactions. For the reasons discussed in section III.B.1.d, however, we have determined not to propose to permit a fund to reduce its exposure for purposes of the rule's portfolio limitations for particular derivatives transactions that may be entered into for hedging (or risk-mitigating) purposes or that may be "cover transactions." As discussed in more detail in that section of this Release, we believe it would be difficult to develop a suitably objective standard for these transactions, and that confirming compliance with any such standard would be difficult, both for fund compliance personnel and for our staff. In addition, many

206 In determining an appropriate exposure limit, we have also considered that, as noted below in section III.B.1.d, derivatives transactions that are intended to hedge or mitigate risks may not be effective, particularly in stressed market conditions.

207 We also note that the payment obligations and potential payment obligations associated with derivatives transactions differ in certain respects from the payment obligations under borrowings permitted under section 18, including in that the fund's payment obligations under a derivatives transaction would vary depending on changes in market prices, volatility, and other market events related to the derivatives transaction's reference asset. *See also* sections III.E and IV.E.

hedges are imperfect, making it difficult to distinguish purported hedges from leveraged or speculative exposures or to provide criteria for this purpose in the proposed rule that would be appropriate for the diversity of funds subject to the proposed rule and the diversity of strategies and derivatives they use or may use in the future.

In addition to these considerations, we also note that, as discussed in section III.B.1.b.i, while an exposure-based test based on notional amounts could be viewed as a relatively blunt measurement, we believe that, on balance, a notional amount limitation would be more administrable, and thus more effective, as a means of limiting potential leverage from derivatives for purposes of the proposed rule than a limitation which seeks to define, and rely on, more precise measurements of leverage. We note that setting the exposure limitation at 150%, as proposed, would allow the fund to use derivatives transactions to obtain a level of indirect market exposure solely through derivatives transactions that could approximate the level of market exposure that would be possible through securities investments augmented by borrowings as permitted under section 18.[208]

We also considered whether higher exposure limitations might be appropriate, such as exposure levels ranging from 200% to 250% of net assets. We are concerned, however, that exposure levels in excess of 150% of net assets, if not tempered by the risk mitigating aspects of the VaR test as we have proposed under the risk-based limit, could be used to take on additional speculative investment exposures that go beyond what would be expected to allow for hedging

208 For example, for a fund that determines to use derivatives as an alternative to investments in securities, this proposed exposure-based limit would permit a fund with $100 in assets and with no liabilities or senior securities to obtain market exposure through a derivatives transaction with a notional amount of up to 150% of the fund's net assets, with the fund's non-derivatives assets invested in cash and cash equivalents. This would match the degree of market exposure the fund could obtain by borrowing up to $50 from a bank as permitted under section 18 and investing the fund's $150 in total assets in securities.

arrangements, and thus could implicate the undue speculation and asset sufficiency concerns expressed in sections 1(b)(7) and 1(b)(8) of the Act.

Second, we considered the extent to which different exposure limits would affect funds' ability to pursue their strategies. In this regard we considered the extent to which different potential exposure limitations would affect funds and their investors, as well as section 18's strict limitations on senior securities transactions and the concerns we discuss above regarding funds' ability to obtain leverage through derivatives and other senior securities transactions. We also considered the extent to which different types of funds, and funds collectively, use senior securities transactions today. Given that, as discussed below, most funds use relatively low notional amounts of derivatives transactions (or do not use any derivatives), we have proposed an exposure limitation at a level that we believe would appropriately constrain funds that use derivatives to obtain highly leveraged exposures.

Third, we recognize and have considered that funds using any derivatives transactions can experience derivatives-related losses, including funds with exposures below the limits we are proposing today as well as the other limits that we discuss above. In this regard, we recognize that the information available in the administrative orders described in section II.D.1.d indicates that some of the losses described as resulting from derivatives in those matters occurred at exposure levels below the exposure limits that we are proposing today.[209] The proposed rule's exposure limits are not designed to prevent all derivatives-related losses, however. Importantly, the exposure limits would be complemented by the rule's asset segregation requirements, which would apply to all funds that engage in derivatives transactions in reliance on the rule, and the proposed rule's risk management requirements, which would apply to funds that have derivatives

[209] *See supra* notes 123-124 and 126.

exposure exceeding a lower threshold of 50% of net assets or that use complex derivatives transactions.

Based on these considerations, we have determined to propose an exposure-based portfolio limit set at 150% of net assets, rather than a lower limit, including the 50% and 100% limits discussed above. We believe that a 150% exposure limit would account for the variety of purposes for which funds may use derivatives, including to hedge risks in the fund's portfolio and to make investments where derivatives may be a more efficient means to obtain exposure. As discussed in more detail below, we have determined not to permit funds to reduce their exposure for potentially hedging or cover transactions and, instead, have proposed an exposure limit that we believe would be high enough to provide funds sufficient flexibility to engage in these kinds of transactions.

We also believe that a 150% exposure limitation would appropriately balance the proposed rule's effects on funds and their investors, on the one hand, with concerns related to funds' ability to obtain leverage through derivatives and other senior securities transactions, on the other. We understand based on the DERA analysis that, although most funds would be able to comply with an exposure-based portfolio limit of 150% of net assets, the limit would constrain the use of derivatives by the small percentage of funds that use derivatives to a much greater extent than funds generally. The analysis also indicates that funds and their advisers generally would be able to continue to operate and to pursue a variety of investment strategies, including alternative strategies.[210]

As discussed in more detail in the DERA White Paper, DERA staff reviewed the portfolio holdings of a random sample of mutual funds (including a separate category of

210 *See infra* note 211.

alternative strategy funds, which includes index-based alternative strategy funds[211]), closed-end funds, BDCs, and ETFs. DERA staff randomly selected 10% of the funds from each of these categories and reviewed the funds' schedule of investments included in their most recently filed annual reports to identify the fund's derivatives transactions, financial commitment transactions, and other senior securities transactions. DERA staff then calculated the funds' exposures under these transactions, using the notional amounts to calculate the funds' derivatives exposures and the amounts of the funds' obligations and contingent obligations under financial commitment transactions and other senior securities transactions, and compared the funds' aggregate exposures to the funds' reported net assets. Although we recognize that the review by DERA staff evaluated funds' investments as reported in the funds' then-most recent annual reports, DERA staff is not aware of any information that would provide any different data analysis of the current use of senior securities transactions by registered funds and business development companies.[212]

This analysis showed that, for mutual funds other than alternative strategy funds (which we discuss separately below), more than 70% of the sampled mutual funds did not identify *any* derivatives transactions in their schedules of investments; about 6% of sampled mutual funds had derivatives exposures in excess of 50% of the funds' net assets; and about 99% of sampled

211 *See supra* note 87 (describing the funds included as alternative strategy funds as part of the staff's review).

212 We understand that, in stable environments, samples including longer periods of time are preferable because their larger sample sizes offer greater precision in estimating a given relation or characteristic. DERA staff analysis shows, however, that funds that make the greatest use of derivatives have received disproportionately large net inflows since the end of 2010. Extending DERA's sample back in time thus would tend to include data in the sample that is no longer consistent with industry practice with respect to derivatives usage as it exists today.

mutual funds had aggregate exposures that were less than 150% of the funds' net assets.[213] None of the sampled closed-end funds had aggregate exposure in excess of 150% of net assets (and only about 2% of those funds had aggregate exposures exceeding 100% of net assets).[214] None of the sampled BDCs reported any derivatives transactions, although some of them did report financial commitment transactions (and they also had issued other senior securities).[215] The sampled ETFs included alternative strategy ETFs and ETFs pursuing other strategies. Of the non-alternative strategy ETFs, only one of the sampled funds had aggregate exposure in excess of 150% of net assets, and the other sampled non-alternative strategy ETFs with relatively higher exposures had exposures of approximately 100% of net assets.[216] With respect to alternative strategy ETFs, the sampled funds with the highest exposures were leveraged ETFs; several of these funds had aggregate exposure exceeding 150% of net assets, with exposure ranging up to approximately 280% of net assets.[217] Based on this analysis we believe that, except for alternative strategy funds and certain leveraged ETFs, most funds should be able to comply with a 150% exposure portfolio limitation without modifying their portfolios.

The sampled alternative strategy funds in DERA's analysis tended to be more significant users of derivatives.[218] Fifty-two percent of the sampled alternative strategy funds had at least 50% notional exposure from derivatives, and approximately 73% of these funds had aggregate

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213 DERA White Paper, *supra* note 73, at Figures 9.5 and 11.5.

214 DERA White Paper, *supra* note 73, at Figure 9.7.

215 DERA White Paper, *supra* note 73, at Figures 9.11 and 11.11.

216 DERA White Paper, *supra* note 73, at Figures 4.6 and 9.9.

217 DERA White Paper, *supra* note 73, at Figure 4.5.

218 We refer to alternative strategy funds in the same manner as the staff classified "Alt Strategies" funds in the DERA White Paper, *supra* note 73, as including the Morningstar categories of "alternative," "nontraditional bond" and "commodity" funds.

exposure that represented less than 150% of net assets.[219] The approximately 73% of funds with exposure under 150% included at least one fund in every Morningstar alternative mutual fund category.[220] The remaining approximately 27% of the sampled alternative strategy funds with aggregate exposure of 150% or more pursued a variety of strategies including, among others, absolute return, managed futures, unconstrained bond, and currency strategies. The funds with the highest exposures in the sample generally followed managed futures strategies.

We believe the proposed 150% exposure limitation appropriately balances the proposed rule's effects on funds and their investors, on the one hand, with the concerns we discuss above concerning funds' ability to obtain leverage and incur obligations through derivatives transactions (and other senior securities transactions), on the other. The information provided in the DERA staff analysis indicates, as discussed above, that most funds in the DERA random sample would be able to comply with a 150% exposure limit without modifying their portfolios. The analysis also indicates that alternative strategy funds, the heaviest users of derivatives in the DERA random sample, generally would be able to continue to operate and to pursue a variety of alternative strategies. As noted above, approximately 73% of the sampled alternative strategy funds had less than 150% exposure and included funds in every alternative mutual fund category.[221] The majority of the sampled ETFs also had exposures of 150% or less of net assets.

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219 DERA White Paper, *supra* note 73, at Figures 9.4 and 11.4.

220 Our staff's experience suggests, however, that funds in one Morningstar alternative strategy category—Managed Futures—may find it difficult to limit their exposures to less than 150%. These funds generally obtain their investment exposures through derivatives transactions, and thus can be expected to have high derivatives exposures relative to net assets. This is consistent with DERA's analysis, in which the funds with the highest exposures were managed futures funds.

221 *See supra* note 220 regarding funds in the Morningstar managed futures category.

Our staff's analysis indicates that it should be possible to pursue, in some form, almost all existing types of investment strategies in compliance with a 150% exposure limitation.[222]

We recognize, however, that particular funds, including particular alternative strategy funds and certain leveraged ETFs, would need to modify their portfolios to reduce their use of derivatives in order to comply with a 150% exposure limitation, and that these funds may view it to be disadvantageous or less efficient to reduce their use of derivatives and the potential returns that they may seek to obtain from such derivatives.[223] On balance, however, we believe a 150% limit provides an appropriate amount of flexibility for funds to engage in derivatives transactions in reliance on the exemption the proposed rule would provide, which otherwise would be prohibited for mutual funds by section 18 (and limited for other types of funds).[224]

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222 In this regard we note that our staff has observed that derivatives transactions may be used by a fund almost entirely to substitute for the purchase of physical securities, with the result that different funds may pursue the same strategy with one fund doing so primarily through derivatives and the other primarily through securities investments. For example, a long/short equity fund that engages in cash transactions could purchase long investment securities and borrow securities in connection with its short sale transactions. Alternatively, the long/short equity fund might invest primarily in Government securities or other short-term investments and pursue its long/short equity strategy solely through a few portfolio total return swaps, under which the fund designates long and short positions and receives the net performance on these reference securities in substantially the same manner as if the fund had invested directly in the reference securities.

223 We also discuss these and other implications of the proposed rule's 150% exposure limitation below in section IV of this Release. A fund with exposure in excess of 150% of net assets might be able to comply with the risk-based portfolio limit, discussed below, which includes an exposure limit of 300% of net assets. We note, however, that a fund that holds only cash and cash equivalents and derivatives—like certain alternative strategy funds and leveraged ETFs—would not be able to satisfy the VaR test because, in this case, the fund's derivatives, in aggregate, generally would add, rather than reduce, the fund's exposure to market risk and thus generally would not result in a full portfolio VaR that is lower than the fund's securities VaR, as required under the VaR test. *See infra* note 314 and accompanying text.

224 In this regard we also note that, as discussed above, the DERA staff analysis shows that approximately 73% of the sampled alternative strategy funds, which are as a group more substantial users of derivatives, had less than 150% exposure. Only those funds that used derivatives to a much greater extent than funds generally, including a limited percentage of alternative strategy funds, had exposures in excess of 150% of net assets.

We believe it is appropriate, and consistent with the investor protection concerns underlying section 18, for funds that engage in derivatives securities transactions in reliance on the exemption that would be provided by proposed rule 18f-4 to be subject to an exposure limit, given that exposures resulting from borrowings and other senior securities are also subject to a limit under section 18. Funds with exposure in excess of the proposed 150% limit thus would have to reduce their exposure in order to rely on the rule. We recognize that a very small percentage of funds may find it difficult to modify their portfolios in order to comply with the proposed 150% exposure limit while pursuing their current strategies.

Some managed futures funds and currency funds, for example, pursue their strategies almost exclusively through derivatives transactions, with the funds' assets generally consisting of cash and cash equivalents. For example, four funds in DERA's sample had exposures in excess of 500% of net assets, and three of them were managed futures funds, with exposures ranging up to approximately 950% of net assets. These funds may find it impractical to reduce their exposures below the proposed limit of 150%.[225] As we discussed above in section II.D.1 of this Release, however, funds with derivatives notional exposures of almost ten times net assets and having the potential for additional exposures do not appear to be subject to a practical limit on leverage as we contemplated in Release 10666.

Certain ETFs and mutual funds expressly use derivatives to achieve performance results, over a specified period of time, that are a multiple of or inverse multiple of the performance of an index or benchmark. Certain of these funds have derivatives exposures exceeding 150% of

225 We note that managed futures funds account for approximately 3% of alternative mutual fund assets under management, and 0.09% of mutual fund assets under management. We thus expect that, although the proposed rule would have a greater effect on managed futures funds than most other types of funds, the effect would be small relative to alternative fund assets under management, and especially small relative to overall mutual fund assets under management.

net assets (*e.g.*, a fund that seeks to deliver two or three times the inverse of a benchmark and achieves this exposure through derivatives transactions), as reflected in the DERA sample and noted above. These funds are sometimes referred to as trading tools because they seek to provide a specific level of leveraged exposure to a market index over a fixed period of time (*e.g.*, a single trading day).

Initially only certain mutual funds pursued these strategies. Today, most of these funds are ETFs operating pursuant to exemptive orders granted by the Commission that provide relief from certain provisions of the Act other than section 18.[226] The first exemptive order that contemplated leveraged ETFs, which was issued by the Commission in 2006,[227] stated that the applicants intended to operate ETFs that would seek investment results of 125%, 150%, or 200% of the return of the underlying securities index on a daily basis (or an inverse return of 100%, 125%, 150%, or 200% of such index on a daily basis).[228] Subsequent orders were issued for two other ETF sponsors seeking to launch and operate leveraged ETFs, some of which involved higher amounts of leverage.[229] No exemptive orders for leveraged ETFs have been issued since 2009.

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226 The applicants did not seek, and their orders do not provide, any exemption from the requirements of section 18. The proposed rule, if adopted, would prohibit funds, including leveraged ETFs, from obtaining exposure in excess of the proposed rule's exposure limits.

227 ProShares Trust, et al., Investment Company Release Nos. 27323 (May 18, 2006) (notice) and 27394 (June 13, 2006) (order).

228 In this Release we generally refer to ETFs that seek to achieve performance results, over a specified period of time, that are a multiple of or inverse multiple of the performance of an index or benchmark collectively as "leveraged ETFs."

229 Rydex ETF Trust, et al., Investment Company Release Nos. 27703 (Feb. 20, 2007) (notice) and 27754 (Mar. 20, 2007) (order); Rafferty Asset Management, LLC, et al., Investment Company Release Nos. 28379 (Sept. 12, 2008) (notice) and 28434 (Oct. 6, 2008) (order). *See also* ProShares Trust, et al., Investment Company Release Nos. Investment Company Release Nos. 28696 (Apr. 14, 2009) (notice) and 28724 (May 12, 2009) (order) (amending the applicant's prior order); Rafferty Asset Management, LLC, et al., Investment Company Release Nos. 28889 (Aug.

The Commission and the staff have continued to consider funds' use of derivatives, including the use of derivatives by ETFs and leveraged ETFs. In August 2009, the staff of our Office of Investor Education and Advocacy and FINRA jointly issued an Investor Alert regarding leveraged ETFs, expressing certain concerns regarding such ETFs.[230] In March 2010, we issued a press release announcing that the staff was conducting a review to evaluate the use of derivatives by registered investment companies, including ETFs, and we indicated that, pending completion of this review, the staff would defer consideration of exemptive requests under the Act relating to ETFs that would make significant investments in derivatives.[231] Although the staff is no longer deferring consideration of exemptive requests under the Act

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27, 2009) (notice) and 28905 (Sept. 22, 2009) (order) (amending the applicant's prior order). These orders (as amended) relate to leveraged ETFs that seek investment results of up to 300% of the return (or inverse of the return) of the underlying index.

230 Investor Alert and Bulletins, *Leveraged and Inverse ETFs: Specialized Products with Extra Risks for Buy-and-Hold Investors* (Aug. 18, 2009), *available at* http://www.sec.gov/investor/pubs/leveragedetfs-alert.htm. FINRA also has sanctioned a number of brokerage firms for making unsuitable sales of leveraged and inverse ETFs. *See, e.g.,* FINRA News Release, *FINRA Orders Stifel, Nicolaus and Century Securities to Pay Fines and Restitution Totaling More Than $1 Million for Unsuitable Sales of Leveraged and Inverse ETFs, and Related Supervisory Deficiencies* (Jan. 9, 2014), *available at* https://www.finra.org/newsroom/2014/finra-orders-stifel-nicolaus-and-century-securities-pay-fines-and-restitution-totaling; *see also* FINRA News Release, *FINRA Sanctions Four Firms $9.1 Million for Sales of Leveraged and Inverse Exchange-Traded Funds* (May 1, 2012), *available at* https://www.finra.org/newsroom/2012/finra-sanctions-four-firms-91-million-sales-leveraged-and-inverse-exchange-traded. Following losses incurred by certain ETF investors during 2008-2009, a lawsuit was brought against one of the sponsors of leveraged ETFs alleging that the funds' registration statements contained material misstatements or omissions. The Circuit Court of Appeals for the Second Circuit affirmed the district court's dismissal of the plaintiffs' claims. In affirming, the court noted, among other things, that, as a disclosure matter, "[a]ll the ProShares I prospectuses make clear that ETFs used aggressive financial instruments and investment techniques that exposed the ETFs to potentially 'dramatic' losses 'in the value of its portfolio holdings and imperfect correlation to the index underlying.'" In re ProShares Trust Securities Litigation, 728 F.3d 96 (2d Cir. 2013) (internal citations omitted).

231 *See* SEC Press Release 2010-45, *SEC Staff Evaluating the Use of Derivatives by Funds* (Mar. 25, 2010), *available at* http://www.sec.gov/news/press/2010/2010-45.htm.

relating to all actively-managed ETFs that make use of derivatives,[232] the staff continues not to support new exemptive relief for leveraged ETFs.

Funds that do not wish to rely on the proposed rule may wish to consider deregistering under the Investment Company Act, with the fund's sponsor offering the fund's strategy as a private fund or as a public (or private) commodity pool, which do not have statutory limitations on the use of leverage.[233] These alternative fund structures would be marketed to a more targeted investor base (*i.e.*, those with higher incomes or net worth, in the case of private funds, and those familiar with commodity pool investment partnerships, in the case of public commodity pools) and would not be expected by their investors to have the protections provided by the Investment Company Act. We also note that our staff has observed that certain of these highly leveraged funds (*e.g.*, managed futures funds) often do not make significant investments in securities and the securities investments they do make generally do not meaningfully contribute to their returns.

We request comment on all aspects of the proposed exposure-based portfolio limit of 150% of a fund's net assets.

- Is 150% an appropriate exposure limit? If not, should it be higher or lower, for example 200% or 100%? Does the 150% exposure limit, together with the rule's other limitations, achieve an appropriate balance between providing flexibility and limiting the amount of leverage a fund could obtain (and thus the potential risks associated with leverage)?

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232 *See* Derivatives Use by Actively-Managed ETFs (Dec. 6, 2012), *available at* http://www.sec.gov/divisions/investment/noaction/2012/moratorium-lift-120612-etf.pdf (announcing that the staff will no longer defer consideration of exemptive requests under the Act relating to actively-managed ETFs that make use of derivatives provided that they include representations to address some of the concerns expressed in the March 2010 press release).

233 *See* section IV below for a discussion of possible effects associated with funds' decision to deregister under the Investment Company Act and for their sponsors to offer the fund's strategy as private funds or commodity pools.

Does the 150% exposure limit effectively address the varying ways in which funds use derivatives, including for hedging purposes?

- Are certain types of funds likely to use the 150% exposure limit exclusively for leveraging purposes? If so, do commenters believe that such a level of exposure would be inappropriate? Should any concerns about a fund using derivatives transactions exclusively for leveraging purposes be addressed through a reduced exposure limitation? Conversely, would the other conditions and requirements of the rule, including the requirement to have a derivatives risk management program meeting specified requirements (discussed in section III.D below), address concerns regarding the leverage that the fund might be able to obtain under the 150% exposure limit, in light of the policy concerns underlying section 18 of the Act?
- Do commenters agree that the proposed 150% exposure limitation appropriately balances concerns regarding, on the one hand, the extent to which the exposure limit would affect funds' investment strategies and, on the other hand, section 18's limitations on the issuance of senior securities and the concerns we discuss above concerning funds' ability to obtain leverage through derivatives transactions and other senior securities transactions?
- As discussed above, our staff's analysis indicates that certain funds, including certain alternative funds, today have exposures exceeding 150% of their net assets. What types of modifications would these funds be required to make and how would the modifications affect their investors? Would they be able to make such modifications? Are there other types of funds that also would expect to have exposure exceeding 150%? If so, what kinds of funds and what types of modifications would they be required to make and how

would the modifications affect their investors? What types of costs would funds that need to modify their investment strategies in order to comply with the 150% limit be likely to incur? Would funds that would be required to make modifications to comply with a 150% exposure limit generally be able to follow the same investment strategy as they do today after making any modifications? How would such modifications likely affect such funds?

- What types of funds would be unable to modify their investment program in order to comply with the 150% exposure limit? Would these funds be likely to continue their investment programs as private funds or public (or private) commodity pools? What would be the effects, positive and negative, on the funds' investors in these cases?
- The 150% exposure limit (and the 300% exposure limit in the risk-based portfolio limit) would apply to all funds without regard to the type of fund or the fund's strategy. Are there certain types of funds for which a higher or lower exposure limit would be appropriate?
    - Should we consider a higher limit for ETFs (or other funds) that seek to replicate the leveraged or inverse performance of an index? Would a higher exposure limit be appropriate for these funds because they may operate as trading tools that seek to provide a specific level of leveraged exposure to a market index over a fixed period of time, and because the amount of leverage is an integral part of their strategy? Conversely, do those same considerations suggest that these funds—which are not restricted to sophisticated investors—should be subject to the same exposure limitations as other types of funds? Some of these funds are ETFs that operate pursuant to exemptive orders granted by the Commission. Would it be

more appropriate to consider these funds' use of derivatives transactions in the exemptive application context, based on the funds' particular facts and circumstances, rather than in rule 18f-4, which would apply to funds generally? Would the exemptive application process be a more appropriate way to evaluate these funds in order to consider their use of leverage together with other features of these products (such as their objective of seeking daily returns) that are not shared by funds generally?

- As discussed in more detail above, some managed futures funds and currency funds pursue their strategies almost exclusively through derivatives transactions, with the funds' other assets generally consisting of cash and cash equivalents. Managed futures and currency funds with derivatives exposures substantially in excess of the funds' net assets may find it impractical to reduce their exposures below the proposed limit of 150%. Do commenters agree that it may be feasible, for the reasons discussed above, for funds that do not wish to rely on the proposed rule to deregister under the Investment Company Act and for the fund's sponsor to offer the fund's strategy as a private fund (which can be offered solely to a limited range of investors) or as a public or private commodity pool? Are these alternatives, which do not have statutory limitations on the use of leverage, feasible vehicles for these types of strategies? Conversely, should we permit managed futures or currency funds (or other specified fund categories) to obtain exposure in excess of 150% of the funds' net assets under the exposure-based portfolio limit? If so, what limit and what other restrictions or limitations on their use of derivatives would be appropriate? Are there ways that we could permit such funds to obtain additional exposure while still addressing the undue speculation concern expressed in section 1(b)(7) and the asset sufficiency concern expressed in section 1(b)(8)? How could we permit such funds to obtain additional exposure while also imposing an effective limit on leverage and on the speculative nature of such funds?

- Section 61 permits a BDC to issue senior securities to a greater extent than other types of funds in that BDCs are subject to a lower asset coverage requirement of 200% (as opposed to the 300% asset coverage requirement that applies to other types of funds).[234] The proposed rule would not restrict the ability of a BDC to continue to issue senior securities pursuant to section 61 subject to a 200% asset coverage requirement. The proposed rule would, however, require a BDC that engages in derivatives transactions in reliance on the proposed rule to comply with the rule's aggregate exposure limitations, which would include exposure associated with senior securities issued by a BDC pursuant to section 61 (as well as exposure from financial commitment transactions entered into by a BDC pursuant to the proposed rule). Should the proposed rule provide BDCs greater exposure limits under the rule in recognition of the greater latitude that BDCs have to issue senior securities provided by section 61? Would any increase be needed given that our staff's review suggests BDCs do not use derivatives to any material extent?

- Are there other types of funds for which, or circumstances under which, we should provide higher or lower exposure limits? What kinds of funds or

[234] *See supra* notes 34-36 and accompanying text.

circumstances and why? Should we provide for differing exposure limits based on characteristics of the fund's derivatives? Which characteristics and how should they affect the level of exposure the fund should be permitted to obtain?

- Should we grandfather funds that are operating in excess of the proposed rule's portfolio limits as of a specified date? If we were to grandfather funds, which funds should we grandfather and why? Should we apply any grandfathering to funds that are operating on the date of this proposal, for example? Alternatively, should we, for example, grandfather leveraged ETFs on the basis that they operate pursuant to the terms and conditions of exemptive orders granted by the Commission? If we were to grandfather funds, should the grandfathering be subject to conditions? Should any grandfathered funds be required to comply with some, but not all, aspects of the proposed rule? For example, should they be required to comply with the proposed rule's asset segregation requirements and the requirement to have a formalized derivatives risk management program? Should they be required to comply with any other conditions?

d. Treatment of Hedging and Cover Transactions

We believe that the 150% exposure-based portfolio limit would permit funds to engage in derivatives transactions to an extent that we believe is appropriate when done in compliance with the proposed rule's other conditions, and would permit a fund relying on the rule to use derivatives for a variety of purposes under the proposed rule, including to seek to hedge or mitigate risks. We have not separately included any provision in the proposed rule to permit a fund to reduce its exposure for purposes of the rule's portfolio limitations for particular derivatives transactions that may be entered into for hedging (or risk-mitigating) purposes or that may be "cover transactions" as described below.[235] We believe that the DERA staff analysis, discussed in section III.B.1.c, suggests that such a reduction is not necessary in order to permit the use of derivatives for hedging or risk-mitigating purposes because most of the funds in DERA's sample did not have aggregate exposure in excess of 150% of net assets. In addition, while we expect that the proposed rule's exposure limitation would be applied relatively consistently across funds, we believe that providing for a hedging reduction may hinder our efforts toward establishing a consistent and effective approach toward the regulation of funds' use of derivatives, and that the exposure limits under the proposed rule are more easily administrable than some other potential alternatives that could entail a more tailored approach.

One substantial concern regarding any hedging or cover transaction exception is that we believe it would be difficult to develop a suitably objective standard for these transactions, and that confirming compliance with any such standard would be difficult, both for fund compliance personnel and for our staff.[236] Our staff has noted that funds may enter into a variety of

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235 *See infra* note 244. The proposed rule would, however, permit a fund to net certain transactions when determining its exposure, as noted above, where the transactions to be netted are directly offsetting derivatives that are the same type of instrument and have the same underlying reference asset, maturity and other material terms. *See* proposed rule 18f-4(c)(3)(i).

236 As discussed in section IV.E, the CESR commitment approach for UCITS funds permits funds to reduce their calculated derivatives exposure for certain netting and hedging transactions, while providing for a lower exposure limit (100% of net assets) than the proposed rule. We note, however, that the challenges of distinguishing between hedging and speculative activity have been considered in numerous regulatory and financial contexts. One recent regulatory example is the exemption for certain risk-mitigating hedging activities from the prohibition on proprietary trading by banking entities in the final rules implementing section 13 of the Bank Holding Company Act (commonly known as the "Volcker Rule"). *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, Release No. BHCA-1 (Dec. 10, 2013) [79 FR 5536 (Jan. 31, 2014)] ("Volcker Rule Adopting Release"), at 5629, 5627. The complexity of distinguishing hedging from speculation in this context is notable because the exemption is designed for entities that would not otherwise be engaged in speculative activity. We believe it would be even more difficult to make such a distinction in the context of funds that in the ordinary course are permitted, and often likely, to use derivatives for both speculative and hedging purposes.

derivatives transactions based on their portfolio managers' views of the expected performance correlations between such transactions and other investments (including other derivatives instruments) made by the funds, and these relationships may be difficult to describe effectively and comprehensively in an exemptive rule of general applicability such as the proposed rule.[237] In addition, many hedges are imperfect,[238] which makes it difficult to distinguish purported hedges from leveraged or speculative exposures. For example, while a fund might use interest rate or currency derivatives primarily for hedging particular investments, the same instruments could be used by the fund to obtain, or could inadvertently result in, leveraged or speculative exposures in a fund's portfolio.[239]

The Concept Release sought comment on the "cover transaction" alternative to liquid asset segregation first addressed by our staff in the Dreyfus Letter as a means of limiting a fund's

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237 *See, e.g.*, MFDF Concept Release Comment Letter, at 4 (noting that "in recent years, funds have adopted more complex and more nuanced investment strategies, and thus are using derivatives – and sometimes the same type of derivative – in many different ways, including as a way of hedging and mitigating other risks present in fund portfolios. Therefore, any detailed and purportedly all-inclusive approach to regulations governing funds' use of derivatives is almost necessarily destined to be out-of-date the moment it is issued.").

238 *See, e.g.*, Federal Reserve Bank of Chicago, *Understanding Derivatives: Markets and Infrastructure* (Aug. 2013), *available at* https://www.chicagofed.org/publications/understanding-derivatives/index, at 27-28 (noting that exchange-traded contracts often give rise to basis risk, i.e., the risk that arises when "the exposure to the underlying asset, liability or commodity that is being hedged and the hedge contract (the derivatives contract) are imperfect substitutes" and that mitigating basis risk may necessitate OTC derivatives that can be tailored to meet specific requirements).

239 One commenter to the Concept Release offered the following hypothetical: A fund holds euro-denominated shares with a market value of €2 million and hedges against exchange rate fluctuations by entering into a 3-month forward contract to sell €2 million for $2.75 million. If the euro value of the shares falls below the notional amount of the currency contract, then it could be viewed as a form of investment leverage, but the alternative – requiring the fund to continuously adjust its hedge to match the value of its security position – could be prohibitively expensive and contrary to the best interest of the fund's shareholders. *See* Keen Concept Release Comment Letter, at 11.

leverage and risk of loss from derivatives.[240] In the Dreyfus Letter, our staff stated that it would not object to a fund covering its obligations by entering into certain other transactions that were intended to position the fund to meet its obligations under the derivatives transaction to be covered or by holding the asset (or the right to acquire the asset) that the fund would be required to deliver under certain derivatives, rather than following the segregated account approach set forth in Release 10666. While commenters to the Concept Release generally argued for retaining the flexibility offered by the cover transaction approach, they also raised numerous issues that demonstrate the difficulties in identifying transactions that should be viewed as providing adequate coverage.[241]

One commenter noted that, although entering into cover transactions "can mitigate the potential for loss and thus the effect of indebtedness leverage," the determination of which transactions actually offset others can be "very complicated."[242] Other issues raised by commenters and in the 2010 ABA Derivatives Report included: whether transactions involving two different counterparties could provide adequate cover for each other; whether positions that are "substantially correlated" could offset each other; whether transactions that are "demonstrably fully or partially offsetting" could cover each other; and whether the cover transaction approach extended to, or should be extended to, other transactions not addressed in

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240 *See* Dreyfus No-Action Letter, *supra* note 55. *See also* Concept Release, *supra* note 3, at nn.70-71 and accompanying text (discussing circumstances under which the staff has provided guidance with respect to whether certain "obligations may be covered by funds transacting in futures, forwards, written options, and short sales").

241 In contrast to the types of hedging (or risk-mitigating) or cover transactions that we discuss in this section, we believe that the proposed rule's netting provision is sufficiently limited in scope and purpose such that allowing netting would be unlikely to raise the concerns discussed in this section. *See supra* section III.B.1.b.i.2.

242 *See* ICI Concept Release Comment Letter, at 14.

the Dreyfus Letter, such as whether a currency forward could be covered with a currency swap, or whether a written CDS could be covered by holding the underlying reference bond.[243]

Some commenters endorsed a "principles-based approach" to these questions, broadly advocating that we allow funds to determine which transactions should be deemed to cover the exposure of another derivatives transaction.[244] Our staff has found through examinations that funds have expanded their reliance on a cover transaction approach for a variety of different strategies involving written and purchased options and long and short futures, which in the staff's view raises concerns regarding whether the risks under such complex combinations of derivatives are in fact covered. We note in this regard that an incorrect determination that two or more transactions are actually covered could leave a fund unprotected against the risks relating to these transactions and could result in undue speculative activity. A principles-based approach to these issues could also implicate a concern raised by one commenter that "different funds could end up with different determinations, perhaps some taking more aggressive positions to allow for greater use of derivatives to drive performance."[245] We therefore do not believe it would be appropriate to permit funds broad discretion under the proposed rule to determine, based on their own interpretations, the types of derivatives transactions that should be exempt from the restrictions underlying section 18 based on their different characteristics purportedly covering the risks associated with other derivatives transactions.

243 *See, e.g.*, ICI Concept Release Comment Letter, at 14; 2010 ABA Derivatives Report, at 19; Oppenheimer Concept Release Comment Letter, at 5; SIFMA Concept Release Letter, at 8.

244 *See, e.g.*, T. Rowe Price Concept Release Comment Letter, at 3 ("Under a principles-based approach, the SEC should also acknowledge that it is possible for a fund to conclude that in certain cases, transactions that are not identical can be offset for coverage purposes (factors that may impact this conclusion are the credit quality of the counterparties, expected correlation between the two transactions, etc.").

245 AQR Concept Release Comment Letter, at 4.

For all of these reasons, we believe it would be more effective to provide for a 150% exposure-based portfolio limit that we believe would provide funds sufficient flexibility to use derivatives for a variety of purposes, including to hedge or mitigate risks as discussed above, rather than proposing a lower exposure limit that includes exceptions for potentially hedging or cover transactions.

We request comment on our determination not to provide for exclusions for hedging and offsetting transactions in the proposed rule.

- As discussed above, the proposed rule generally would not permit a fund to reduce its exposure for purposes of the rule's portfolio limitations for particular types of potentially hedging, risk-mitigating or cover transactions, and instead would seek to provide funds sufficient flexibility to engage in these transactions by permitting a fund to have exposure of up to 150% of net assets (or 300% under the risk-based limit discussed below). Do commenters agree that this is an appropriate approach?
- Should we, instead, reduce the amount of aggregate exposure a fund would be permitted to obtain but permit funds to reduce their exposure for particular derivatives transactions that are entered into for hedging or risk-mitigating purposes or that are cover transactions? If we were to take this approach, what would be an appropriate exposure limit? Should we, for example, limit a fund's exposure under this approach to 100% of the fund's net assets? Would it be possible to provide comprehensive guidance or prescribe in a rule the types of transactions that appropriately should be permitted to reduce a fund's exposure without requiring the kinds of instrument-by-instrument determinations required under the current approach? If so, how?

### 2. *Risk-Based Portfolio Limit*

As an alternative to the exposure-based portfolio limit, the proposed rule includes a risk-based portfolio limit that would permit a fund to enter into derivatives transactions, and obtain exposure in excess of that permitted under the exposure-based portfolio limit, if the fund complies with the VaR-based test described below (the "VaR test"). The risk-based portfolio limit, including the VaR test, is designed to provide an indication of whether a fund's derivatives transactions, in aggregate, have the effect of reducing the fund's exposure to market risk, as measured by the VaR test. A fund that elects the risk-based portfolio limitation under the proposed rule would also be subject to an exposure limit, but would be permitted to obtain exposure under its derivatives transactions and other senior securities transactions of up to 300% of the fund's net assets.[246]

As discussed in section II.B above, the concerns underlying section 18 include the undue speculation concern expressed in section 1(b)(7) of the Act that "excessive borrowing and the issuance of excessive amounts of senior securities" may "increase unduly the speculative character" of a fund's common stock.[247] As we noted in Release 10666, leveraging a fund's portfolio through the issuance of senior securities "magnifies the potential for gain or loss on monies invested" and therefore "results in an increase in the speculative character" of the fund's outstanding securities. Section 18 seeks to address this concern by limiting the obligations a fund could incur through senior securities transactions. However, although derivatives transactions involve the issuance of senior securities, funds can use derivatives in ways that may not necessarily magnify a fund's potential for gain or loss, or result in an increase in the

246 Proposed rule 18f-4(a)(1)(ii).

247 *See* section 1(b)(7) of the Investment Company Act; *see also supra* section II.B.

speculative character of the fund. For example, commenters have indicated that some fixed-income funds use a range of derivatives, including CDS, interest rate swaps, swaptions and futures, and currency forwards, and that these derivatives are being used, in part, to seek to mitigate the risks associated with a fund's bond investments, or to achieve particular risk targets, such as a specified duration.[248] Such strategies, or other strategies that funds currently use or may develop in the future, may involve the use of derivatives that, in the aggregate, have relatively high notional amounts, but which are used in a manner that could be expected to reduce a fund's potential for gain or loss due to market movements and thereby result in a fund being less speculative than if the fund did not use derivatives. We believe that it may be appropriate for a fund to be able to obtain exposure in excess of that permitted under a portfolio limitation focused solely on the level of a fund's exposure where the fund's use of derivatives, in aggregate, has the effect of reducing the fund's exposure to market risk.[249]

The risk-based alternative under the proposed rule therefore is designed to provide an alternative portfolio limitation that focuses primarily on a risk assessment of a fund's use of derivatives, in contrast to the exposure-based portfolio limit, which focuses solely on the level of

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248 *See, e.g.*, BlackRock Concept Release Comment Letter, at 25 (noting "the use of a derivative to mitigate some or all of the risk inherent in physical positions held in a fund portfolio, such as purchase of a put option on a stock `to provide downside price protection, use of an interest rate swap to shorten the duration of a bond portfolio or the sale of a currency forward to reduce the currency exposure of a bond denominated in a currency other than US dollars"); ICI Concept Release Comment Letter, at 25 ("[f]ixed income funds frequently use derivatives to structure and control duration, yield curve, sector, and/or credit exposures").

249 As used in this Release, "market risk" refers to the risk of financial loss resulting from movements in market prices, and includes both *general* market risk, which refers to the risk associated with movements in the markets as a whole, and *specific* market risk, which refers to the risk associated with movements in the price of a particular asset. *See, e.g.,* Edward Platen & Gerhard Stahl, *A Structure for General and Specific Market Risk,* 18 COMPUTATIONAL STATISTICS 355 (Sept. 2003), *available at* http://www.fe-tokyo.kier.kyoto-u.ac.jp/symposium/platen/sympo_platen_02.pdf.; *see also* Gregory Brown & Nishad Kapadia, *Firm-Specific Risk and Equity Market Development*, 84 J. OF FIN. ECON. 358 (May 2007), *available at* http://www.sciencedirect.com/science/article/pii/S0304405X06002145.

a fund's exposure.[250] The risk-based portfolio limit reflects our belief that if a fund's use of derivatives, in the aggregate, can reasonably be expected to result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives—if the fund's derivatives use reduces rather than magnifies the potential for loss from market movements—then the fund's derivatives use is also less likely to implicate the undue speculation concern expressed in section 1(b)(7). As discussed further below, we believe that the VaR test would be an appropriate way to evaluate if a fund's derivatives use, in the aggregate, decreases the fund's overall exposure to market risk, and that it therefore may be appropriate for the proposed rule to allow a fund that satisfies the VaR test to have greater exposure under its derivatives transactions than would be permitted for a fund operating under the exposure-based portfolio limit.

a. VaR Test Under the Risk-Based Portfolio Limit

To satisfy the VaR test under the risk-based portfolio limit, a fund's full portfolio VaR would have to be less than the fund's securities VaR immediately after the fund enters into any

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250 We believe that the inclusion of the risk-based alternative in the proposed rule, and in particular its use of the VaR test, is consistent with the views expressed by some commenters to the Concept Release and the FSOC Notice suggesting that concerns about leverage be addressed by using risk-based measures, such as VaR, as an alternative or supplement to traditional leverage metrics. *See*, *e.g.*, Comment Letter of Nuveen Investments to the FSOC Request for Comment (Mar. 25, 2015) ("Nuveen FSOC Comment Letter"), *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2014-0001-0051, at 6-7 (noting the firm's use of "different tools to measure the effects of leverage and its accompanying risks," and noting, when using VaR, that "[i]t is helpful, for example, to "determine the VaR of a fund's portfolio both before and after the addition of leverage, to compare both the unleveraged and leveraged metrics to those of the benchmark"); Oppenheimer Concept Release Comment Letter, at 3 (advocating for "the use of VaR for measuring and mitigating the potential exposure and risks of derivatives in an investment company's portfolio for funds making sophisticated and extensive use of derivatives"). Some commenters also suggested the use of VaR as a means of determining asset segregation requirements for funds. *See, e.g.,* SIFMA Concept Release Comment Letter, at 7; BlackRock Concept Release Comment Letter, at 5; ICI Concept Release Comment Letter, at 12.

senior securities transaction.[251] A fund's "full portfolio VaR" would be defined as the VaR of the fund's entire portfolio, including securities, derivatives transactions and other investments.[252] A fund's "securities VaR" would be defined as the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions.[253] As explained below, we believe that the determination by a fund that its full portfolio VaR is less than its securities VaR would be an appropriate indication that the fund's derivatives use, in the aggregate, decreases the fund's overall exposure to market risk.

The proposed rule defines VaR as "an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence level," which we believe is generally consistent with definitions of VaR that are used in other regulatory regimes as well as in academic literature.[254] While VaR can be calculated using several different approaches and a wide range of parameters (as discussed

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251 Proposed rule 18f-4(a)(1)(ii).

252 Proposed rule 18f-4(c)(11)(i)(B).

253 Proposed rule 18f-4(c)(11)(i)(A). Although the proposed rule uses the term "securities VaR," some instruments that a fund could hold, and that would need to be included in the fund's securities VaR, may not be "securities" for all purposes under the federal securities laws. For example, a fund's securities VaR would include any direct holdings of non-U.S. currencies. A fund's securities VaR would also include derivative instruments that do not entail a future payment obligation for a fund (and thus are not "derivatives transactions" as defined in the rule), such as most purchased options.

254 Proposed rule 18f-4(c)(11). *See, e.g.,* Form PF (defining VaR as "[f]or a given portfolio, the loss over a target horizon that will not be exceeded at some specified confidence level"). *See also* Volcker Rule Adopting Release, *supra* note 236, at Appendix A (defining Value-at-Risk as "the commonly used percentile measurement of the risk of future financial loss in the value of a given set of aggregated positions over a specified period of time, based on current market conditions." *See also* Darrell Duffie & Jun Pan, *An Overview of Value at Risk,* 4 THE J. OF DERIVATIVES 7 (Spring 1997) ("For a given time horizon *t* and confidence level *p*, the value at risk is the loss in market value over the time horizon *t* that is exceeded with probability 1-*p*"). *See also* Michael Minnich, PERSPECTIVES ON INTEREST RATE RISK MANAGEMENT FOR MONEY MANAGERS AND TRADERS (Frank Fabozzi, ed.) ("Minnich"), at 39 ("VAR can be defined as the maximum loss a portfolio is expected to incur over a specified time period, with a specified probability").

further below), VaR has certain characteristics that we believe make it an appropriate metric, when used as part of the VaR test, for assessing the effect of derivatives use on a fund's exposure to market risk.

First, VaR generally enables risk to be measured in a comparable and consistent manner across diverse types of instruments that may be included in a fund's portfolio, and provides a means of integrating the market risk associated with different instruments into a single number that provides an overall indication of market risk.[255] By contrast, many other risk metrics used by funds are suited to particular categories of instruments and, given the diverse investment portfolios of many funds, may be less suitable as a means of assessing risk for purposes of the risk-based alternative under the proposed rule.[256] For example, risk measures for government bonds can include duration, convexity and term-structure models; for corporate bonds, ratings and default models; for stocks, volatility, correlations and beta; for options, delta, gamma and vega; and for foreign exchange, target zones and spreads.[257] Because proposed rule 18f-4 is intended to apply generally to all funds that use derivatives, however, and because VaR can be applied across diverse types of instruments that may be included in the portfolios of funds that

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255 *See* Kevin Dowd, AN INTRODUCTION TO MARKET RISK MEASUREMENT (Oct. 2002) ("Dowd"), at 10 (VaR "provides a *common* consistent measure of risk across different positions and risk factors. It enables us to measure the risk associated with a fixed-income position, say, in a way that is comparable to and consistent with a measure of the risk associated with equity positions"). *See also* Zvi Weiner, *Introduction to VaR (Value-at-Risk)* ("Weiner") (May 1997), *available at* http://pluto.mscc.huji.ac.il/~mswiener/research/Intro2VaR3.pdf (noting that VaR provides "an integrated way to deal with different markets and different risks and to combine all of the factors into a single number" that indicates the overall risk level).

256 *See* Weiner, *supra* note 255.

257 *See id.* We have proposed to require certain funds to report some of these metrics on proposed Form N-PORT, such as portfolio-level duration (DV01 and SDV01) and position-level delta, because we believe that such information would be useful to the Commission and to investors. *See* Investment Company Reporting Modernization Release, *supra* note 138.

pursue different strategies, we believe that VaR is a more appropriate metric for purposes of the proposed rule.[258]

Second, VaR can be used to assess the effect of the addition of a position, or group of positions, on the overall market risk of a portfolio. If the addition of a position to a portfolio increases VaR, the position can generally be viewed as adding to a fund's exposure to market risk, while if the addition of a position decreases VaR, it can be viewed as reducing the fund's exposure to market risk.[259]

We believe that these characteristics allow the VaR test to be used as a means of evaluating whether a fund uses derivatives in a manner that would be less likely to implicate the concerns underlying section 18. Section 18 does not restrict a fund's ability to invest in securities and other investments that would be included in a fund's securities VaR, but rather, restricts the ability of a fund to leverage its exposure to such investments by borrowing, or issuing debt or preferred equity, through senior securities. This reflects the concern that the addition of leverage generally will cause a fund to become more speculative and expose investors to potentially greater risk of loss due to market movements than if the fund were

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258 *See*, *e.g.*, Katerina Simons, *The Use of Value at Risk by Institutional Investors* ("Simons"), NEW ENG. ECON. REV. 21 (Nov./Dec. 2000), *available at* http://www.bostonfed.org/economic/neer/neer2000/neer600b.pdf (noting that VaR is "particularly useful" for an investor that "has a multi-asset-class portfolio and needs to measure its exposure to a variety of risk factors. VaR can measure the risk of stocks and bonds, commodities, foreign exchange, and structured products such as asset-backed securities and collateralized mortgage obligations (CMOs), as well as off-balance sheet derivatives such as futures, forwards, swaps, and options." See *also infra* section III.B.2.b.

259 *See* Dowd, *supra* note 255, at 117-118 (defining incremental VaR (or "IVaR") as the change in VaR associated with the addition of a new position to a portfolio, and noting that "IVaR gives us an indication of how [portfolio] risks change when we change the portfolio itself. In practice, we are often concerned with how the portfolio risk changes when we take on a new position, in which case the IVaR is the change in portfolio VaR associated with adding the new position to our portfolio.").

unlevered. As discussed above, a fund's use of derivatives transactions may cause a fund to become more speculative or expose investors to greater risk of loss, but may also be used to mitigate risks in the fund's portfolio.

Whether a fund's use of derivatives exposes the fund to greater risk or less risk than if the fund did not use derivatives requires consideration of the risk characteristics of a fund's non-derivatives investments and its derivatives transactions, and the interaction of the risk characteristics of these investments and transactions with each other. The VaR test provides a means for making such an assessment, by providing an indication of whether the market risk associated with a fund's portfolio of securities and other investments exclusive of derivatives (as measured by the fund's securities VaR), is greater than or less than the market risk associated with the fund's portfolio as a whole (as measured by the fund's full portfolio VaR), inclusive of derivatives transactions and taking into account the offsetting risk characteristics of different instruments in a fund's portfolio. If a fund's full portfolio VaR is less than its securities VaR – *i.e.*, if the fund can satisfy the VaR test – we believe that the fund's derivatives use, in the aggregate, can be viewed as decreasing the fund's overall exposure to market risk.[260] In this way, we believe that a fund's compliance with the VaR test would indicate that the fund's derivatives transactions do not, in the aggregate, result in an increase in the speculative character of the fund, and that the fund's use of derivatives transactions thus would be less likely to implicate the undue speculation concern expressed in section 1(b)(7).[261]

260 *See also*, *e.g.*, Nuveen FSOC Comment Letter, at 6 (noting the firm's use of different "tools to measure the effects of leverage and its accompanying risks," and noting, when using VaR, that "[i]t is helpful, for example, to determine the VaR of a fund's portfolio both before and after the addition of leverage, to compare both the unleveraged and leveraged metrics to those of the benchmark").

261 By contrast, if a fund used derivatives transactions solely for the purpose of leveraging its

We also believe permitting a fund to use derivatives transactions in these circumstances, and subject to the other requirements in the proposed rule, is broadly consistent with the policies and provisions of the Investment Company Act, which seeks to prevent funds from becoming unduly speculative by means of leveraging their assets through the issuance of senior securities, but generally does not impose limitations on a fund's ability to invest in risky or volatile securities instruments.[262] Similarly, the VaR test is designed to limit a fund's ability to use derivatives transactions in order to address undue speculation concern expressed in section 1(b)(7) of the Act, but does not seek to limit the risk or volatility of the fund's investments more generally.

An additional benefit of using VaR in the risk-based portfolio limit is that, based on outreach conducted by our staff, we understand that VaR calculation tools are widely available and that many advisers already use risk management or portfolio management platforms that include VaR capability.[263] We expect that the funds that would rely on the risk-based portfolio

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physical portfolio – for example, by holding a long-only portfolio of large cap equity and obtaining further exposure to those securities through a basket total return swap – the additional market risk incurred by the fund would cause the fund's full portfolio VaR to be greater than its securities VaR. *See, e.g.*, Jacques N. Gordon & Elysia Wai Kuen Tse, *VaR: A Tool to Measure Leverage Risk*, 29 THE J. OF PORTFOLIO MANAGEMENT 62 (Summer 2003) (demonstrating how VaR increases as the degree of leverage added to a portfolio increases and noting that "[b]y comparing the value at risk of different leverage levels to the unleveraged result, we can calculate the incremental risk due to leverage").

262 *See, e.g.*, 1994 Report, *supra* note 32, at 27 (noting that the Act "imposes few substantive limits on mutual fund investments" and that funds "generally are permitted to make investments without regard to their volatility").

263 *See, e.g.*, BNY Mellon, *Risk Roadmap: Hedge Funds and Investors' Evolving Approach to Risk* (Aug. 2012), *available at* http://www.thehedgefundjournal.com/sites/default/files/riskroadmap.pdf (noting that third-party administrators to hedge funds "provide advanced risk functions" to investors such as "[d]aily VaR analysis using multiple models". *See also* Christopher L. Culp, Merton H. Miller & Andres M. P. Neves, *Value at Risk: Uses and Abuses*, 10 J. OF APPLIED CORP. FIN. 26 (Jan. 1998) (VaR is "used regularly by nonfinancial corporations, pension plans and mutual funds, clearing organizations, brokers and futures commission merchants, and insurers").

limit are funds with exposure approaching, or in excess of, the 150% exposure limit included in the exposure-based portfolio limit, and advisers to the funds that use derivatives more extensively may be particularly likely to already use risk management or portfolio management platforms that include VaR capability. Further, as discussed in section III.B.2.b below, VaR models also can be tailored in numerous ways in order to incorporate and reflect the risk characteristics of a fund's particular strategy and investments.[264]

The following example demonstrates how the VaR test would be used under the proposed rule to assess whether a fund's derivatives, in aggregate, result in an investment portfolio that is subject to more or less market risk than if the fund did not use such derivatives. Suppose that a fund has a net asset value of $100 million and holds a portfolio of non-U.S. debt securities, and that the fund calculates the VaR of such securities, using a VaR model that meets the requirements of the proposed rule, to be $3 million. Suppose further that the fund wishes to hedge some of its credit risk by purchasing CDS, adjust its duration by entering into interest rate swaps, and enter into currency forwards both to obtain exposure to certain foreign currencies and to hedge some of its exposure to euro and yen currency risk. If the VaR of its full portfolio (*i.e.*, its securities investments plus its derivatives transactions) immediately after entering into these derivatives transactions is less than $3 million, the fund would comply with the risk-based portfolio limit's VaR test.

264 *See infra* section III.B.2.b. For example, fund advisers that manage UCITS funds may already be using VaR to comply with the requirements of the "relative VaR" and "absolute VaR" approaches under the UCITS regulatory scheme (discussed below in this section and in section IV.E.). *See, e.g.*, AQR Concept Release Comment Letter (noting that the firm is "familiar with the 'value at risk' or VaR methodologies, both through [its] management of UCITS funds and as an effective tool for day-to-day overall firm risk management").

The VaR test under the risk-based portfolio limit is similar in certain ways to the "relative VaR" approach used by some UCITS funds. Under the relative VaR approach, the VaR of the UCITS fund's portfolio cannot be greater than twice the VaR of an unleveraged benchmark securities index (referred to as a "reference portfolio").[265] In contrast to the relative VaR approach for UCITS funds, the VaR test under the proposed risk-based portfolio limit would use a fund's own portfolio of securities and other investments (exclusive of derivatives) as the baseline against which the fund's full portfolio VaR (inclusive of derivatives ) would be compared. For the reasons discussed below, we believe the proposed rule's VaR test offers advantages over a relative VaR approach based on a hypothetical reference portfolio.[266]

First, we believe that the VaR test under the proposed rule is more consistent with the policies and provisions of the Investment Company Act, which restricts in section 18 a fund's ability to issue senior securities but otherwise generally does not impose limitations on a fund's ability to invest in risky or volatile securities investments, provided that such investments are consistent with the investment strategy described to investors. Using the fund's own portfolio as the baseline for the VaR test under the proposed rule—and thus providing a risk assessment of the fund's use of derivatives in the context of the fund's investment strategy disclosed to investors, which may include risky or volatile securities—would be more consistent with the Act. A relative VaR test, by contrast, could be viewed as a limitation on risk or volatility

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265 *See infra* section IV.E.

266 We understand that some UCITS funds also may use an absolute VaR approach, which limits the maximum VaR that a UCITS fund can have relative to its net assets, generally at 20 percent of the UCITS fund's net assets. *See* section IV.E. As discussed in more detail below, we believe that our proposed rule's use of VaR—to assess whether a fund's derivatives as a whole directionally increase or mitigate risk, rather than to precisely estimate potential losses—may be a more effective way to use VaR to provide a risk assessment of a fund's use of derivatives for purposes of section 18 of the Investment Company Act.

generally—as opposed to a limitation on the issuance of senior securities—because it would measure the VaR of a fund's portfolio, including non-senior securities investments, against a hypothetical reference portfolio, and such non-senior securities investments could cause the fund to fail a relative VaR test.[267] Second, we are also concerned that under a relative VaR approach it would be difficult, in light of the wide range of fund strategies and potential benchmarks, to require funds to select benchmarks that are appropriate (particularly in connection with alternative strategies),[268] are unleveraged,[269] and would otherwise serve as an appropriate baseline against which the relative VaR should be measured.[270]

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[267] For example, a sector-focused equity fund (e.g., focusing on financial or commodity-focused stocks) that used a broad-based large cap equity index as its benchmark under a relative VaR test could potentially fail to comply with the test if the sector experienced a period of unexpected volatility, even if the fund did not use a significant amounts of derivatives. In this case the volatility associated with the fund's equity investments, rather than its derivatives transactions, could cause the fund to fail the relative VaR test.

[268] The difficulty of identifying appropriate benchmarks for purposes of assessing the performance of alternative funds illustrates some of the potential challenges that identifying an appropriate benchmark for purposes of a relative VaR test could entail. For example, our staff has noted that many alternative funds use LIBOR or a Treasury bill rate of interest plus a spread (*e.g.*, 4 percentage points) for their performance benchmark. It has been observed, however, that although such benchmarks reflect return, they may understate risk, which raises concerns that they may not be effective for purposes of a test that would compare a fund's VaR to a benchmark VaR. *See* Richard J. Harper, *Absolute Tracking: Moving Past Absolute Return for Hedge Fund Benchmarking* (May 2013), *available at* http://www.nepc.com/writable/research_articles/file/2013_03_nepc_absolute_tracking_update.pdf (noting that the "fundamental problem with absolute return benchmarks" is that they "reflect only return" and "understate risk").

[269] Our staff has observed that some alternative funds use hedge fund indices for performance benchmarking, but such indices would not be appropriate for comparing a fund's VaR to the benchmark VaR because the hedge funds included in the benchmark generally can be expected to use leverage. *See id.* (hedge fund benchmarks "vary widely with regard to long/short exposure, leverage, capitalization, sector focus, international diversification, and optionality").

[270] *See* Daisy Maxey, *Benchmarking Alternative Funds an Inexact Science*, WALL STREET JOURNAL (Apr. 10, 2014), *available at* http://www.wsj.com/articles/SB10001424052702304058204579493590377289408 (citing statement from Morningstar's director of alternative funds research that "more often than not, there is no single good measure" for benchmarking alternative funds and therefore "multiple benchmarks must be used").

While we believe that there are significant benefits to using VaR in the risk-based portfolio limit, we also recognize that significant attention has been given (especially since the 2007-2009 financial crisis) to the limitations of VaR and the risks of overreliance on VaR as a risk management tool.[271] One widely expressed concern with VaR is that it does not adequately reflect "tail risks" (i.e., the size of losses that may occur on the trading days during which the greatest losses occur).[272] Another concern is that VaR calculations may underestimate the risk of loss under stressed market conditions.[273]

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271 *See, e.g.*, James O'Brien & Pawel J. Szerszen, *An Evaluation of Bank VaR Measures for Market Risk During and Before the Financial Crisis*, Federal Reserve Board Staff Working Paper (Mar. 7, 2014) ("[c]riticism of banks' VaR measures became vociferous during the financial crisis as the banks' risk measures appeared to give little forewarning of the loss potential and the high frequency and level of realized losses during the crisis period"). *See also* Pablo Triana, *VaR: The Number That Killed Us*, FUTURES MAGAZINE (Dec. 1, 2010), *available at* http://www.futuresmag.com/2010/11/30/var-number-killed-us (noting that "in mid-2007, the VaR of the big Wall Street firms was relatively quite low, reflecting the fact that the immediate past had been dominated by uninterrupted good times and negligible volatility").

272 In the regulatory context, VaR gained widespread usage by banks and other financial institutions following the 1996 Market Risk Amendment to the Basel II Capital Accords (the "Market Risk Amendment"), which set forth a framework of qualitative and quantitative standards for allowing banks to determine capital charges for market risks they incurred, by using proprietary internal models. The Basel Committee on Bank Supervision (BCBS) modified this framework in 2009, by introducing an additional capital charge based on a "stressed VaR" calculation – that is, VaR calibrated to a period of significant financial stress.

More recently, the BCBS has proposed the use of "stressed expected shortfall". Expected shortfall is similar to VaR but differs from VaR in that it accounts for tail risk by taking the average or expected losses beyond the specified confidence level; "stressed" expected shortfall refers to expected shortfall calculated using a model that is calibrated to a period of significant financial stress. The BCBS has recognized that, while it believes that a shift to stressed expected shortfall would "account[] for the tail risk in a more comprehensive manner, considering both the size and likelihood of losses above a certain threshold", it also presents challenges, including the difficulty of identifying a stress period using a full set of risk factors for which historical data is available and potentially greater sensitivity of expected shortfall to extreme outlier losses. *See* Bank for International Settlements, Basel Committee on Banking Supervision, *Fundamental review of the trading book: A revised market risk framework* (Oct. 2013) ("BCBS Trading Book Review – Oct. 2013).

273 *See, e.g.*, Amit Mehta, Max Neukirchen, Sonja Pfetsch & Thomas Poppensieker, *Managing Market Risk: Today and Tomorrow*, McKinsey Working Papers on Risk, No. 32 (May 2012).

Under the proposed rule, however, VaR would be used to focus primarily on the relationship between a fund's securities VaR and its full portfolio VaR, rather than on the absolute magnitude of the potential loss of any particular investment or the fund's portfolio as a whole. We believe that this use of VaR—to assess whether a fund's derivatives as a whole directionally increase or mitigate risk, rather than to precisely estimate potential losses—mitigates some of the concerns that have been expressed about the use of VaR.[274] In addition, the VaR test under the risk-based portfolio limit would be coupled with an outside limit on exposure, which, as discussed in section III.B.2.c below, would provide an independent limit on a fund's use of senior securities transactions under the proposed rule that would not be based on VaR.

We also recognize that funds may use measures other than VaR in order to assess the risks posed by a fund's derivatives and other investments.[275] The VaR test is designed to serve as a means of limiting a fund's ability to leverage its assets in a manner that would implicate the undue speculation concern in section 1(b)(7) of the Act, but it is not intended as a substitute for other measures that a fund may consider in connection with its derivatives risk management. For

274 *See infra* section III.B.2.b (discussing the proposed rule's requirements concerning the VaR models that a fund would be permitted to use for purposes of the VaR test and the requirement that, regardless of which VaR model the fund chooses, the fund must use the same VaR model, and apply it consistently, in the calculation of the fund's securities VaR and full portfolio VaR).

275 *See, e.g.*, Frank J. Ambrosio, *An Evaluation of Risk Metrics*, Vanguard Investment Counseling & Research (2007), *available at* https://personal.vanguard.com/pdf/flgerm.pdf (discussing various risk metrics used by fund managers, including absolute risk measures such as standard deviation (the degree of fluctuation in a portfolio's return), risk of loss (the percentage of outcomes below a certain total return level) and shortfall risk (the probability that an investment's value will be less than is needed to meet portfolio objectives), and relative risk measures such as excess return (a security's return above or below that of a benchmark or risk-free asset), tracking error (the standard deviation of excess return), Sharpe ratio (a measurement of how much return is being obtained for each theoretical unit of risk), information ratio (the risk-adjusted return of a portfolio versus a benchmark), beta (the magnitude of an investment's price fluctuations relative to the ups and downs of the overall market) and Treynor ratio (the risk-adjusted return of a portfolio or security versus the market).

example, those funds that are subject to the requirement to have formalized derivatives risk management programs should consider other appropriate measures to assess risk, including stress tests that are tailored to a fund's particular characteristics, as part of their derivatives risk management programs, as discussed in section III.D below.[276] We also recognize that the use of derivatives poses other risks, such as counterparty risk and liquidity risk, that may not be addressed by the VaR test under the proposed rule; however, we believe, as discussed in section III.D below, that funds making significant use of derivatives generally should address these risks as part of their risk management programs.[277] We have proposed that the risk-based portfolio limit include a VaR-based test because of the characteristics of VaR we discussed above, which we believe allow VaR to be used as part of the VaR test to provide an indication of whether a fund's derivatives as a whole directionally increase or mitigate risk.

We request comment immediately below on the proposed rule's inclusion of a risk-based portfolio limitation based on VaR and, in section III.B.2.b below, we request comment on the proposed rule's requirements regarding funds' use of particular VaR models in connection with the VaR test and the proposed rule's requirements for any VaR model chosen by the fund.

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276 As discussed below in section III.D, the proposed rule would require a fund that relies on proposed rule 18f-4 to enter into derivatives transactions to have a formalized risk management program unless the fund limits its exposure from derivatives transactions to 50% or less of the fund's net assets (and does not use complex derivatives transactions). We expect that all funds that would operate under the risk-based limit would have derivatives exposure in excess of 50% of net assets, and thus would be required to have risk management programs, because funds with derivatives exposure of 50% or less would be able to comply with the 150% exposure limit and have no need to avail themselves of the higher 300% exposure limit for funds that comply with the risk-based portfolio limit.

277 Proposed rule 22e-4 also would require a fund subject to that rule to assess and periodically review the fund's liquidity risk, considering various factors specified in the rule, including the fund's use of borrowings and derivatives for investment purposes. *See supra* note 81 and accompanying text.

- Do commenters agree that the proposed rule should include, in addition to the exposure-based portfolio limit, an alternative portfolio limitation that focuses primarily on a risk assessment of a fund's use of derivatives? Do commenters agree that, where a fund's derivatives transactions, in the aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives, it would be appropriate to permit the fund to engage in derivatives transactions to a greater extent than would be permitted under any exposure-based portfolio limit?
- As noted above, we are proposing to include the risk-based portfolio limit in the proposed rule because we recognize that, because derivatives transactions may be used for a variety of purposes, some funds may make use of derivatives that in the aggregate result in relatively high notional amounts, but which are not used to leverage the fund's assets in a manner that increases the fund's exposure to market risk. What types of funds have or could have exposure in excess of the limit provided in the exposure-based portfolio limit (150% of net assets) but use derivatives transactions that, in the aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives? Are there funds that today use derivatives in amounts greater than the exposure-based portfolio limit but could comply with the risk-based portfolio limit? If so, what kinds of funds? If funds would have to restructure their portfolios to comply with the risk-based portfolio limit, how would they do so? Would they be able to pursue strategies or obtain investment exposures similar to their current strategies

and exposures? If not, what types of strategies or investment exposures would not be possible?

- The proposed rule would use the VaR test to determine if a fund's derivatives transactions, in aggregate, result in an overall portfolio that is subject to less market risk than if the fund did not use such derivatives. Do commenters agree that VaR, as used in the VaR test, is an effective approach for this purpose? Are there other measures we should permit a fund to use, either in lieu of or in addition to VaR, to assess whether the fund's derivatives transactions, in the aggregate, have the effect of mitigating the fund's exposure to market risk? For example, would absolute risk measures (such as standard deviation, risk of loss or shortfall risk), relative risk measures (such as excess return, tracking error, Sharpe ratio, information ratio, beta or Treynor ratio), or stress testing / scenario generation, better address the purposes that the VaR test is intended to fulfill?[278] If so, how would such risk measures be incorporated into a test for purposes of the risk-based portfolio limit?
- As discussed above, we believe that the manner in which VaR would be used under the proposed rule, which focuses on the relationship between a fund's securities VaR and its full portfolio VaR, would mitigate some of the concerns that have been expressed regarding the risks and limitations of relying on VaR as a risk measure. Do commenters agree? If not, what alternative measures could be implemented to address these concerns? For example, would these concerns be addressed by requiring funds to comply with a test that is similar to the VaR test,

278 *See supra* note 275 (discussing different types of absolute and relative risk measures).

but that uses expected shortfall instead of VaR (i.e., that would require a fund to compare the expected shortfall of its securities portfolio with the expected shortfall of its full portfolio)?[279]

- The risk-based portfolio limit would require a fund's full portfolio VaR to be less than its securities VaR. Should the test be more restrictive or less restrictive? For example, should we permit a fund's full portfolio VaR to exceed its securities VaR up to a specified limit (e.g., allow the fund's full portfolio VaR to exceed its securities VaR by not more than a specified percentage)? For example, would it be appropriate for the fund's full portfolio VaR to exceed its securities VaR by 10% or 20%? Conversely, should we make the test more restrictive and require that the fund's full portfolio be less than the fund's securities VaR by an amount specified in the rule? Should we, for example, require that the full portfolio VaR be 10% or 20% less than the fund's securities VaR?
- For purposes of the risk-based portfolio limit, should the proposed rule use an approach such as (or similar to) the relative VaR or absolute VaR approach for UCITS funds, instead of or as an alternative to the proposed VaR test? Why or why not? Would it be more efficient to allow funds to use such an approach – e.g., because some advisers already use this approach for UCITS funds? Under a relative VaR approach, what sort of benchmarks would or would not be appropriate, and how should the benchmarks be chosen? Under an absolute VaR approach, what would be an appropriate VaR limit (e.g., 20%, as for UCITS funds, or a higher or lower limit)? Would a relative VaR or absolute VaR

279 *See supra* note 272 (discussing the use of expected shortfall under BCBS proposal).

approach appropriately address the undue speculation concern underlying section 18? Why or why not?

- A fund's securities VaR would be the VaR of the fund's investments other than derivatives transactions which, as defined in the proposed rule, would include derivatives transactions that involve the issuance of a senior security. The VaR associated with derivatives that do not involve the issuance of a senior security, such as a typical purchased option, would be included in the fund's securities VaR. Although section 18 does not limit a fund's ability to acquire such derivatives, they could be volatile and thus could generate a securities VaR that would provide the fund additional latitude to engage in derivatives transactions under the risk-based portfolio limit. Should we, therefore, require the fund to exclude the VaR associated with *all* of the fund's derivatives from the securities VaR, whether or not they involve the issuance of a senior security, and, if so, how should we define "derivatives" for this purpose? If so, what would be the effects on funds' strategies?
- Should we place other limitations on a fund's ability to use borrowings or other financial commitment transactions to obtain leveraged exposures if the fund elects to use derivatives at the higher level permitted under the risk-based portfolio limit? Should we, for example, further restrict a fund's ability to use financial commitment transactions or other borrowings, the proceeds of which could be used by the fund to purchase securities investments that would increase the fund's securities VaR?

- Are there certain types of securities, derivatives or other instruments that would be difficult to model using VaR (taking into account the requirements for a fund's VaR model, discussed in section III.B.2.b below)? For example, would it be difficult for a fund to model an investment in a private fund, or in other types of illiquid investments that lack frequent valuations or transparency? Are there ways that we should modify the VaR test to allow a fund that invests in instruments that are difficult to model using VaR to demonstrate in some other way that its derivatives, in aggregate, are risk mitigating?

b. Choice of Model and Parameters for VaR Test

The proposed rule defines VaR as "an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence interval."[280] We believe that this is generally consistent with the commonly understood definition of VaR as a risk measure.[281] We also believe that, while VaR can be calculated using a number of different approaches and a wide range of parameters, this definition is broad enough to encompass most methods of calculating VaR. However, while we believe it is appropriate for funds to have flexibility in the selection of a VaR model and its parameters for purposes of the risk-based portfolio limit, we also believe that a fund's VaR model should meet certain minimum requirements. As discussed further below, the proposed rule therefore would require a fund's VaR model to take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments.[282] In addition, the proposed rule would

280 Proposed rule 18f-4(c)(11).

281 *See supra* note 280.

282 Proposed rule 18f-4(c)(11)(ii)(A).

require a fund to use a minimum 99% confidence interval,[283] a time horizon of not less than 10 and not more than 20 trading days,[284] and a minimum of three years of historical data to estimate historical VaR.[285] A fund would also be required to apply its VaR model consistently when calculating its securities VaR and full portfolio VaR.[286] We discuss these aspects of the proposed rule below.

First, the proposed rule would require a fund's VaR model to take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments.[287] Absent this requirement, the fund's VaR calculations, when used in the VaR test, may not provide a reliable indication of whether the fund's derivatives, in aggregate, are increasing or decreasing the fund's overall portfolio's exposure to market risk. The proposed rule provides a non-exclusive list of risk factors that may be relevant in light of a fund's strategy and investments, including equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk,[288] material risks arising from the nonlinear price characteristics of options and positions with embedded optionality,[289] and the sensitivity of the market value of the fund's derivatives to changes in volatility or other material market risk factors.[290]

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283 Proposed rule 18f-4(c)(11)(ii)(B).

284 Proposed rule 18f-4(c)(11)(ii)(B).

285 Proposed rule 18f-4(c)(11)(ii)(C).

286 Proposed rule 18f-4(c)(11)(i)(C).

287 Proposed rule 18f-4(c)(11)(ii)(A). "Market risk" for this purpose includes both general market risk and specific market risk. *See supra* note 249.

288 Proposed rule 18f-4(c)(11)(ii)(A)*(i)*.

289 Proposed rule 18f-4(c)(11)(ii)(A)*(ii)*.

290 Proposed rule 18f-4(c)(11)(ii)(A)*(iii)*.

We understand that VaR models are often categorized into three methods—historical simulation,[291] Monte Carlo simulation,[292] or parametric models.[293] We also understand that each method has certain benefits and drawbacks, which may make a particular method more or less suitable, depending on a fund's strategy, investments and other factors. In particular, some VaR methodologies may not adequately incorporate all of the material risks inherent in particular investments, or all material risks arising from the nonlinear price characteristics of certain derivatives.[294] While the proposed rule does not specify that a fund must use any particular type of VaR model, the proposed rule would require that any VaR model used by the fund take into

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291 Historical simulation models rely on past observed historical returns to estimate VaR. Historical VaR involves taking a fund's current portfolio, subjecting it to changes in the relevant market risk factors observed over a prior historical period, and constructing a distribution of hypothetical profits and losses. The resulting VaR is then determined by looking at the largest (100 minus the confidence level) percent of losses in the resulting distribution. *See, e.g.*, Dowd, *supra* note 255, at 56-68. *See also* Thomas J. Linsmeier & Neil D. Pearson, *Value at Risk*, FIN. ANALYSTS J. (Mar.-Apr. 2000) ("Linsmeier & Pearson"), at 50-53.

292 Monte Carlo simulation uses a random number generator to produce a large number (often tens of thousands) of hypothetical changes in market values that simulate changes in market factors. These outputs are then used to construct a distribution of hypothetical profits and losses on the fund's current portfolio, from which the resulting VaR is ascertained by looking at the largest (100 minus the confidence level) percent of losses in the resulting distribution. *See, e.g.*, Dowd, *supra* note 255, at 221; Linsmeier & Pearson, *supra* note 291, at 53-56 (discussing the "delta-normal approach," a form of parametric method).

293 Parametric methods to calculating VaR rely on estimates of key parameters (such as the mean returns, standard deviations of returns, and correlations among the returns of the instruments in a fund's portfolio) to create a hypothetical statistical distribution of returns for a fund, and use statistical methods to calculate VaR at a given confidence level. *See, e.g.*, Dowd, *supra* note 255, at 37; Linsmeier & Pearson, *supra* note 291, at 56-57.

294 For example, some parametric methodologies may be more likely to yield misleading VaR estimates for assets or portfolios that exhibit non-linear returns, due, for example, to the presence of options or instruments that have embedded optionality (such as callable or convertible bonds). *See, e.g.,* Linsmeier & Pearson, *supra* note 291, at 57 (noting that historical and Monte Carlo simulation "work well regardless of the presence of options and option-like instruments in the portfolio. In contrast, the standard [parametric] delta-normal method works well for instruments and portfolios with little option content but not as well as the two simulation methods when options and option-like instruments are significant in the portfolio.").

account and incorporate all significant, identifiable market risk factors associated with the fund's investments, as discussed above, and to meet the rule's other requirements for a VaR model.

As discussed below in section III.D, the proposed rule would require funds that are subject to the requirement to have a formalized derivatives risk management program under the proposed rule to periodically review and update any VaR calculation models used by the fund, in order to evaluate their effectiveness and reflect changes in risks over time.[295] As part of its derivatives risk management program, a fund that relies on the risk-based portfolio limit may wish to consider periodic backtesting or other procedures to assess the effectiveness of its VaR model, and in particular, may wish to use such testing to periodically assess whether its VaR model takes into account and incorporates all significant, identifiable market risk factors associated with the fund's investments.[296]

The proposed rule would require a fund using historical VaR to have at least three years of historical market data.[297] We understand that the availability of data is a key consideration when using historical simulation to estimate VaR, and that the length of the data observation period may significantly influence the results of a VaR calculation. For example, a shorter observation period means that each observation will have a greater influence on the result of the VaR calculation (as compared to a longer observation period), such that periods of unusually high or low volatility could result in unusually high or low VaR estimates.[298] Longer observation

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295 Proposed rule 18f-4(a)(3)( i)(D).

296 Backtesting refers to "the application of quantitative, typically statistical, methods to determine whether a model's risk estimates are consistent with the assumptions on which a model is based." Dowd, *supra* note 255, at 141. If backtesting indicates that a model consistently overestimates or underestimates VaR, it may be because a fund's VaR model is not taking into account and incorporating the appropriate market risk factors associated with the fund's investments.

297 Proposed rule 18f-4(c)(11)(ii)(C).

298 *See* Linsmeier & Pearson, *supra* note 291, at 59 (noting that, because historical simulation relies

periods, however, can lead to data collection problems, if sufficient historical data is not available.[299] By requiring a fund using historical VaR to have at least three years of historical market data, the proposed rule is designed to require a fund to base its VaR estimates on a sufficient number of observations, while also recognizing the concern that requiring a longer historical period could make it difficult for a fund to obtain sufficient historical data to estimate VaR for the instruments in its portfolio.[300]

The proposed rule would also require a fund to use a 99% confidence level for its VaR test.[301] Many regulatory schemes that use VaR require a 99% confidence level, which can be expected to result in higher estimates of absolute losses than a lower confidence interval.[302] As discussed above, the VaR test under the proposed rule's risk-based portfolio limit is designed to focus on the relationship between a fund's securities VaR and its full portfolio VaR, rather than

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directly on historical data, "[a] danger is that the price and rate changes in the last 100 (or 500 or 1,000) days might not be typical. For example, if by chance the last 100 days were a period of low volatility in market rates and prices, the VAR computed through historical simulation will understate the risk in the portfolio.").

299 *See* Dowd, *supra* note 255, at 68 (noting that "[a] long sample period can lead to data collection problems. This is a particular concern with new or emerging market instruments, where long runs of historical data don't exist and are not necessarily easy to proxy.").

300 *See also* Minnich, *supra* note 254, at 43 (noting that for historical simulation, "[l]onger periods of data have a richer return distribution while shorter periods allow the VAR to react more quickly to changing market events" and that "[t]hree to five years of historical data are typical.") *See also* Darryll Hendricks, *Evaluation of Value-at-Risk Models Using Historical Data*, FRBNY ECON. POLICY REV. (Apr. 1996), at 44 (finding that, when using historical VaR, "[e]xtreme [confidence interval] percentiles such as the 95th and particularly the 99th are very difficult to estimate accurately with small samples" and that the complete dependence of historical VaR models on historical observation data "to estimate these percentiles directly is one rationale for using long observation periods.").

301 Proposed rule 18f-4(c)(11)(ii)(B).

302 For example, UCITS funds that use the relative VaR or absolute VaR approach are required to calculate the fund's VaR using a 99% confidence interval. *See* CESR Global Guidelines, *supra* note 162, at 26 (requiring funds that use the relative VaR or absolute VaR approach to calculate VaR using a "one-tailed confidence interval of 99%"). As noted in section III.B.2.a above and in section IV.E below, the VaR test under the risk-based portfolio limit is similar in certain respect to the relative VaR approach for UCITS funds.

to serve as an absolute measure of potential losses. Although the VaR test is not designed to provide an estimate of a fund's potential absolute losses, we believe that a 99% confidence interval would be more appropriate, as compared to a lower confidence interval, because a higher confidence level would provide a stronger indication that a fund's derivatives use, in aggregate, can be expected to have a risk-mitigating effect on the fund's exposure to market risk on the days on which the fund's securities portfolio would be expected to incur the greatest losses.

The proposed rule also would require a fund to calculate VaR using a time horizon of at least 10 trading days but not more than 20 trading days.[303] We understand that when VaR is used for risk management purposes, the time horizon that is selected by the user typically reflects the expected holding period for an instrument (or portfolio of instruments).[304] The holding period, in turn, may depend on factors such as the liquidity of an instrument and the purpose for which it is held, which may vary across different types of instruments in a portfolio.[305] When VaR is used for regulatory purposes, however, the applicable regulation typically specifies a time horizon or range of permissible time horizons (even in cases where the regulated entity may hold instruments or a portfolio having a longer or shorter expected holding period), in order to promote consistency across regulated entities and use a time horizon for the VaR calculation is appropriate in light of the underlying regulatory purpose.[306] In light of this, we considered the

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303 Proposed rule 18f-4(c)(11)(ii)(B).

304 *See, e.g.*, *infra* at discussion accompanying notes 295-296.

305 *See, e.g.*, Bank for International Settlements, Basel Committee on Banking Supervision, *Messages from the Academic Literature on Risk Measurement for the Trading Book*, Working Paper No. 19 (Jan. 31, 2011) ("Basel Risk Measurement Working Paper") (noting, based on a survey of academic literature on VaR-based approaches to risk management, that "[t]here seems to be consensus among academics and the industry that the appropriate horizon for VaR should depend on the characteristics of the position").

306 The underlying regulatory purpose could include, for example, limiting the amount of market risk that could be incurred by an investment vehicle and thus mitigating the risk of potential losses

factors discussed below in determining to propose a 10- to 20-day time horizon for a fund's VaR model under the proposed rule.

First, we understand that very short time horizons (e.g., one day) can be less effective at capturing the effects of fluctuations in risk factors on VaR, particularly with respect to out-of-the-money options (or implicit options, for securities and other investments that contain option-like features). At the same time, we understand that, while VaR estimates of potential losses typically increase as the time horizon increases over short- to medium-term periods, over longer periods VaR estimates of potential losses may eventually decrease.[307] Thus, we considered that if the proposed rule did not specify a time horizon or range of acceptable time horizons, some funds that rely on the risk-based portfolio limit could select a time horizon for their VaR model that is either too short or too long and thereby underestimate potential losses, as reflected in the VaR test. In light of these concerns, we believe it would be appropriate for the proposed rule to place some limitations on a fund's ability to use shorter or longer time horizons that could produce less reliable VaR estimates, while also providing some flexibility for a fund to select a time horizon that is appropriate based on the fund's particular characteristics.[308]

Second, we considered that the VaR test is designed to provide an indication, through a fund's comparison of its securities VaR to its full portfolio VaR, that the fund's derivatives

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that investors would bear, or establishing capital requirements. *See infra* at notes 310-311 and accompanying text.

307 *See, e.g.*, Dowd, *supra* note 255, at 73-74 (showing how parametric VaR can initially result in increasing estimates of loss as the time horizon increases, but that estimates of loss can decrease over longer time horizons). Estimated VaR losses over longer time horizons can also be affected by the tendency of volatility to be mean-reverting over time. *See generally* Stephen Figlewski, ESTIMATION ERROR IN THE ASSESSMENT OF FINANCIAL RISK EXPOSURE (2003).

308 Thus, for example, a fund that invests a greater proportion of its assets in liquid instruments and trades frequently might choose a 10-day holding period, while a fund that invests in less liquid instruments or trades less frequently might choose a longer holding period (but not longer than 20 days).

transactions, in aggregate, have the effect of reducing the fund's exposure to market risk. This means that the VaR test requires a portfolio-level calculation, and for such purposes the fund would need to select a single time horizon, even if the fund expected to hold different instruments in its portfolio for different lengths of time.[309] A consequence of this is that even if a fund uses VaR for internal risk-management purposes and applies different time horizons to different types of instruments for such purposes, the fund nevertheless would need to select a single holding period for purposes of the VaR test.

Third, we considered the time horizons in other regulatory regimes that use VaR. In this regard, we noted that the most commonly used time horizons appear to be either 10 days or 20 days. For example, the 1996 Market Risk Amendment to the Basel II Capital Accord, which contemplated banks' use of internal models for measuring market risk, incorporated a 10-day time horizon.[310] For UCITS funds that rely on the relative VaR or absolute VaR approach, the CESR Global Exposure Guidelines specify a 20-day time horizon.[311] A consequence of the use of 10- and 20-day time horizons under these regimes is that we believe that these time horizons are widely used by funds and other financial market participants.

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309 While a fund could in theory model different instruments using different VaR time horizons, it is not clear that a fund would be able to incorporate different time horizons into a portfolio-wide VaR test. *See, e.g.*, Basel Risk Measurement Working Paper, *supra* note 305 (noting, based on a survey of academic literature on VaR-based approaches to risk management, that "[a]t present, there is no widely accepted approach for aggregating VaR measures based on different horizons").

310 *See* BCBS Trading Book Review – Oct. 2013, *supra* note 272. The BCBS has implemented and continues to develop new standards which, among other things, would call for five different "liquidity horizon categories" for broad categories of risk factors, ranging from 10 days to one year. As noted above, however, the VaR test under the proposed rule effectively requires a fund to select a single time horizon. *See supra* note 272 and accompanying text.

311 *See* CESR Global Guidelines, *supra* note 162, at 26 (requiring funds that use the relative VaR or absolute VaR approach to calculated VaR using a "holding period equivalent to 1 month (20 business days"). *See also infra* section IV.E.

In light of these considerations, including balancing concerns about a time horizon potentially being too long or too short with the benefit of providing some level of flexibility for funds to select a time horizon in light of their particular characteristics, we believe the proposed rule's requirement that the time horizon for the VaR model used by a fund that complies with the risk-based portfolio limit is appropriate.

Finally, regardless of which VaR model the fund chooses, the fund must apply its VaR model consistently when calculating the fund's securities VaR and the fund's full portfolio VaR. This requirement is designed to prevent a fund from using different models to manipulate the results of the VaR test—for example, by overestimating the fund's securities VaR using one VaR model and underestimating its full portfolio VaR using a different model in order to take on riskier derivatives positions. In addition, because the VaR test would be used to focus on the relationship between the fund's securities VaR and its full portfolio VaR as discussed above, requiring the fund to use the same VaR model for purposes of the VaR test would help to ensure that the test generates comparable estimates of the fund's securities VaR and full portfolio VaR.

We request comment on the proposed rule's minimum requirements concerning the VaR model used by the fund.

- Do funds today use VaR models for risk management purposes or otherwise that would meet the proposed rule's minimum requirements? If funds use VaR models that would not meet these requirements, how do they differ?
- Should the proposed rule specify a particular VaR model(s) that funds must use (*i.e.*, a historical simulation, Monte Carlo simulation, or parametric methodology)? If so, which methodology (or methodologies) and why?

- A fund would only be permitted to use a historical VaR methodology if at least three years of historical data is available. Do commenters agree that this is an appropriate requirement? Would requiring three years of historical data make it difficult to model some instruments? Should we require that a fund have additional historical return data in order to use a historical VaR methodology? Conversely, would less than three years of historical return data be sufficient?
- The proposed rule would require that the VaR model used by the fund (whether based on the historical simulation, Monte Carlo simulation, or parametric method) incorporate all significant, identifiable market risk factors associated with a fund's investments. Do commenters agree that this is an appropriate standard? Is it sufficiently clear?
- The proposed rule would provide a non-exclusive list of risk factors that may be relevant in light of a fund's strategy and investments, including equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk, all material risks arising from the nonlinear price characteristics of options, and positions with embedded optionality, and the sensitivity of the market value of the fund's derivatives to changes in volatility or other material market risk factors. Do commenters agree that these are appropriate risk factors? Are there others we should include? Rather than include a non-exclusive list of risk factors that funds must consider, should we specify in any final rule the particular risk factors that must be included in specified circumstances? Would it be possible to do so in a way that would address the diversity of funds and their strategies?

- The proposed rule would require a fund to use a 99% confidence level for its VaR test. Do commenters agree that this is an appropriate confidence level? In particular, should we permit funds to use a lower confidence interval? Why or why not?
- The proposed rule would require a fund to calculate VaR using a time horizon of at least 10 trading days, but not more than 20 trading days. Do commenters agree that it is appropriate to provide a range of trading days, to give funds some flexibility in selecting a time horizon based on the fund's own particular characteristics? Do commenters agree that a range of 10 to 20 trading days would be appropriate? Should the number of trading days be lower than 10, or higher than 20? Should the number of trading days be a specific number, instead of a range? Why or why not? If so, which specific number would be appropriate? Should we, for example, specify 10 or 20 trading days?
- Regardless of which VaR model the fund chooses, the proposed rule would require the fund to apply its VaR model consistently when calculating the fund's securities VaR and the fund's full portfolio VaR. Do commenters agree that this requirement is appropriate? If not, how could we otherwise prevent the VaR test from being easily manipulated?
- We believe that the proposed rule affords appropriate flexibility for funds to tailor the VaR test in light of a fund's strategy, investments and other relevant factors. Does this flexibility increase the risk that funds will be able to game or manipulate the test in order to obtain riskier investment exposures? If so, should

the rule impose more specific requirements on a fund's VaR model or its parameters, and how?

- Should the proposed rule place restrictions on a fund's ability to change its VaR model? For example, should changes be permitted only with the approval of the fund's derivatives risk manager, or subject to other approval or oversight requirements?

c. 300 Percent Exposure Limit Under the Risk-Based Portfolio Limitation

A fund that relies on the risk-based portfolio limit would be required to limit its exposure to not more than 300% of the fund's net assets, rather than 150% (as would be required under the exposure-based portfolio limit). While we believe that the VaR test generally would indicate that the fund's derivatives transactions do not, in the aggregate, result in an increase in the speculative character of the fund as discussed above, we also believe it is appropriate for the risk-based portfolio limit to include an outside limit on exposure as discussed in this section.

If the risk-based portfolio limit did not include an outside limit on exposure, a fund might be able to use strategies that may not produce significant measurable amounts of VaR during normal market periods, but which employ derivatives exposures at a level that could subject a fund to a significant speculative risk of loss if markets become stressed. For example, some funds use strategies that entail large long and short notional exposures, with the expectation that the risk of the fund's long positions is largely offset by the fund's short positions during normal market conditions, and this may result in the fund having a low full portfolio VaR. During periods of market stress, however, correlations across different positions may break down, leading to the possibility of significant losses and payment obligations with respect to the fund's derivatives transactions.[312] Although a fund pursuing such a strategy might be considered hedged or balanced, we believe that its activities may be speculative—and that its use of derivatives could implicate the undue speculation concern expressed in section 1(b)(7) of the Act—if the fund's derivatives exposures are very large in comparison to the fund's net assets. In these circumstances the fund's use of derivatives could create an amount of leverage—and a resulting potential for large losses and payment obligations under derivatives—that we believe under some circumstances or market conditions could "increase unduly the speculative character" of the fund's securities issued to common shareholders. Coupling the VaR test with a 300% exposure limit, instead of permitting such a fund to obtain unlimited exposures, is designed to address these considerations by placing an outside limit on the fund's exposure that is not based on a VaR or other risk-based assessment.

We believe that the proposed rule's outside exposure limit of 300% is important to address possible concerns regarding the effectiveness of the VaR test in all possible circumstances and market conditions while also preserving the utility of the risk-based portfolio limit for funds that use derivatives, in aggregate, to result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives. In determining to propose a 300% exposure limit as part of the risk-based portfolio limit we considered, as discussed above in connection with the exposure-based portfolio limit, that the vast majority of funds would be able to comply with a 150% exposure limit without modifying their portfolios. In considering the extent to which the risk-based portfolio limit should permit a fund to obtain additional exposure, in light of the derivatives' aggregate reduction in the fund's exposure to market risk, we also considered the extent to which funds included in the DERA sample with

312 *See, e.g., supra* note 128 and accompanying discussion.

exposures exceeding 150% of net assets would appear to be able to satisfy the VaR test (including by modifying their portfolios to a certain extent in order to do so). Although the information disclosed by the sampled funds and otherwise available to our staff was not sufficient to allow our staff to calculate the funds' securities VaRs and full portfolio VaRs,[313] the available information about the funds does provide an indication of whether the funds reasonably could be expected to comply with the VaR test.

As discussed above, most of the funds included in the analysis conducted by DERA staff with the highest exposures were alternative strategy funds, with approximately 27% of these funds having exposures in excess of 150% of net assets, with the funds' exposures ranging up to approximately 950% of net assets. The funds with the highest exposures were managed futures funds—as noted above, three of the four funds in DERA's sample with exposures exceeding 500% of net assets were managed futures funds with exposures ranging from a little over 500% to approximately 950% of net assets. Managed futures funds, and other funds that use derivatives primarily to obtain market exposure (rather than to reduce the fund's exposure to market risk) and whose physical holdings consist mainly of cash and cash equivalents, would not satisfy the VaR test.[314]

313 While we have proposed in the Investment Company Reporting Modernization Release to obtain additional information regarding derivatives transactions on proposed Form N-PORT, we do not currently have sufficient information in a structured format to evaluate derivatives holdings in the DERA sample of funds discussed in the White Paper to estimate those funds' securities VaRs and full portfolio VaRs.

314 A fund that holds only cash and cash equivalents and derivatives would not be able to satisfy the VaR test. In this case the fund's securities VaR would reflect the VaR of the cash and cash equivalents, and thus would be very low. The fund's derivatives, in aggregate, generally would add to, rather than reduce, the fund's exposure to market risk and thus generally would not result in a full portfolio VaR that is lower than the fund's securities VaR, as required under the VaR test.

Alternative strategy funds with exposures exceeding 150% that potentially could choose to use derivatives in a manner that would satisfy the VaR test had lower exposures. Funds in this group with lower exposures included those with unconstrained bond and multi-alternative strategies; the exposures of funds within these strategies that were in excess of 150% ranged from around 175% to just under 350% of net assets. These funds, and particularly unconstrained bond funds, may have securities investments that involve market risks that could be reduced by derivatives transactions, and thus could consider electing to comply with the risk-based portfolio limit (including by modifying their portfolios to a certain extent in order to do so). We believe that including a 300% exposure limit as part of the risk-based portfolio limit thus would appear to provide a limit that may be appropriate for the kinds of funds that could seek to operate under the risk-based portfolio limit. We note that the 300% exposure limit is only expected to serve as an adjunct limitation on a fund given the primary importance of the VaR test with respect to the risk-based portfolio limit. While we are seeking comment regarding the sufficiency of this exposure limit, we note that setting the exposure limit higher than 300% of net assets—in addition to potentially raising concerns about a fund operating with exposures at that level—would not appear to further the purposes of the risk-based portfolio limit. This is because funds in the DERA sample that have exposures substantially in excess of 300% of net assets would not appear to be able to satisfy the VaR test in any event, as discussed above. Accordingly, we believe that the 300% exposure limit is appropriate as a meaningfully higher limit than the 150% portfolio limit while providing an upper bound that does not appear to unduly constrain funds that may use derivatives on balance for risk-mitigating purposes.

We believe, based on these considerations and those discussed above in section III.B.1, that the proposed rule's outside exposure limit of 300% would address the concerns that led us to propose an exposure limit as part of the risk-based portfolio limit, while also preserving the utility of the risk-based portfolio limit for funds that use derivatives, in aggregate, to result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives.

We request comment on all aspects of the proposed risk-based portfolio limitation's inclusion of an outside limit of 300% of net assets.

- Do commenters agree that an outside limit on exposure can mitigate the concerns we discuss above concerning fund's use of strategies that could be considered hedged or balanced but that might experience speculative losses under certain circumstances? Why or why not? Are there other means to address these concerns that we should consider either in addition to or in lieu of an outside limit on the fund's exposure?
- Do commenters agree that the proposed 300% outer limit on exposure is appropriate? Do commenters agree that a 300% exposure limit would address the concerns we discuss above while also preserving the utility of the risk-based portfolio limit for funds that use derivatives, in aggregate, to result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives? Should we make it higher or lower, for example 250% or 350%, and how would a different limit address the concerns we discuss above?

*3. Implementation and Operation of Portfolio Limitations*

The proposed rule would require, to the extent that a fund elects to rely on the rule, the fund's board of directors, including a majority of the directors who are not interested persons of the fund, to approve which of the two alternative portfolio limitations will apply to the fund.[315] We believe that requiring a fund's board, including a majority of the fund's independent directors, to approve the fund's portfolio limitation would appropriately focus the board's attention on the nature and extent of a fund's use of derivatives and other senior securities transactions as part of its investment strategy. We believe that requiring the fund's board to approve a fund's portfolio limitation would be an appropriate role for the board.[316]

A fund relying on the rule would be required to comply with the applicable portfolio limitation after entering into any senior securities transaction, that is, any derivatives transaction or financial commitment transaction entered into by the fund pursuant to the proposed rule, or any other senior security transaction entered into by the fund pursuant to section 18 or 61 of the Act.[317] A fund therefore would not be required to terminate or otherwise unwind a senior securities transaction solely because the fund's exposure subsequently increased beyond the exposure limits included in either of the portfolio limitations. The fund, however, would not be permitted to enter into any additional senior securities transactions while relying on the exemption provided by the rule unless the fund would be in compliance with the applicable portfolio limitation immediately after entering into the transaction. This aspect of the proposed rule is designed to prevent a fund from having to unwind or terminate a senior securities transaction that the fund was permitted to enter into under the proposed rule at a later time when

315 Proposed rule 18f-4(a)(5)(i).

316 Other exemptive rules under the Act similarly require the fund's board to take certain actions in order for the fund to rely on the exemption provided by the rule. *See, e.g.*, rules 18f-3, 17a-7, 10f-3, and 2a-7.

317 Proposed rule 18f-4(a)(1)(i) and (ii).

terminating or unwinding the transactions may be disadvantageous to the fund.[318] The Act and our rules similarly measure compliance with certain portfolio limitations immediately after a fund acquires a security.[319] However, if a fund's exposure exceeded the applicable exposure limit and the fund entered into a new senior securities transaction, including a new senior securities transaction that was intended to reduce the fund's exposure, the fund would be required to reduce its exposure so that in the aggregate, its exposure was in compliance with the exposure limit.[320]

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318 We similarly proposed an acquisition test (in contrast to a maintenance test) in proposed rule 22e-4, under which a fund would not be permitted to acquire any less liquid asset if, immediately after the acquisition, the fund would have invested less than its three-day liquid asset minimum in three-day liquid assets. Proposed rule 22e-4(b)(2)(iv)(C). In the Liquidity Release we noted that forced sales required under a maintenance test could require the fund to sell the less liquid assets at prices that incorporate a significant discount to the assets' stated value, or even at fire sale prices; we also noted that, if a fund needed to rebalance its portfolio frequently to maintain a specified percentage of the fund's net assets invested in three-day liquid assets, this could produce unnecessary transaction costs adversely affecting the fund's NAV, and could cause a fund to sell portfolio assets when it is not advantageous to do so (*e.g.*, when an asset's price is low, or when sales of an asset would have an undesirable tax impact). *See* Liquidity Release, *supra* note 5, at text accompanying nn.344-48. We similarly believe that requiring a fund to unwind or otherwise terminate derivatives transactions as a result of subsequent changes in the fund's net assets could have adverse consequences for the fund.

319 This acquisition test (in contrast to a maintenance test) reflects approaches that Congress and the Commission have historically taken in other parts of the Investment Company Act and the rules thereunder. *See*, *e.g.*, Investment Company Act section 5(c) (a registered diversified company that at the time of its qualification meets the diversification requirements specified in Investment Company Act section 5(b)(1) shall not lose its status as a diversified company because of any subsequent discrepancy between the value of its various investments and the requirements of section 5(b)(1), so long as any such discrepancy existing immediately after its acquisition of any security or other property is neither wholly nor partly the result of such acquisition); rule 2a-7(d)(3) (portfolio diversification requirements of rule 2a-7 are determined at the time of portfolio securities' acquisition); rule 2a-7(d)(i) (limit on a money market fund's acquisition of illiquid securities if, immediately after the acquisition, the money market fund would have invested more than 5% of its total assets in illiquid securities); rule 2a-7(d)(4)(ii)-(iii) (minimum daily liquidity requirement and minimum weekly liquidity requirement of rule 2a-7 are determined at the time of portfolio securities' acquisition).

320 For example, suppose that a fund's exposure was initially 140% but subsequently increased to 160% solely due to losses in the value of the fund's securities portfolio. The fund would not be required to unwind its senior securities transactions in order to bring its exposure below 150%. However, if the fund entered into any new senior securities transaction then, immediately after

We request comment on all aspects of the operation of the proposed portfolio limitations.

- Does requiring a fund to comply with the proposed rule's portfolio limitations immediately after entering into any senior securities transaction pose any operational challenges, for example, in determining the notional amount of the transaction, the fund's net assets, or the fund's securities VaR or full portfolio VaR (if applicable)?
- The proposed rule would not require a fund to terminate a derivatives transaction if the fund complied with the applicable portfolio limitation immediately after entering into the transaction, even if, for example, the fund's net assets later declined with the result that the fund's exposure at that later time exceeded the relevant exposure limit. Do commenters agree that this is appropriate? Conversely, should we instead require a maintenance test for notional amounts such that funds would be required to adjust their derivatives transactions if the exposure exceeds 150% of net assets for longer than a certain period of time, even if the fund has not entered into any senior securities transactions? If so, should we consider including a cushion amount – for example, by only requiring a fund to adjust its positions if its exposure reaches a higher level, such as 175%? Should we limit the time period (*e.g.*, to 30 days, 60 days, or 90 days) in which a exposure could exceed 150% of net assets (or 300% under the risk-based portfolio limit) as a result of changes in the fund's net assets so that a fund cannot persistently exceed the rule's exposure limits? Would such an approach better promote investor protection? Would there be operational challenges with this requirement?

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entering into such transaction, the fund would be required to be in compliance with the 150% exposure limit.

- If a fund's exposure were to exceed the applicable exposure limit, should the proposed rule permit the fund to engage in a series of derivatives transactions where those transactions ultimately would reduce the fund's exposure below the applicable exposure limit, even if the fund's exposure were not below the applicable limit immediately after entering into certain of these transactions, in order to make it easier for funds to reduce their exposure under multiple derivatives transactions on a *pro rata* basis? If so, how would we permit these kinds of transactions without providing a means for funds to maintain exposure levels in excess of the applicable exposure limit for long periods of time? Should we, for example, permit funds to engage in a group of substantially contemporaneous derivatives transactions where the fund's exposure is below 150% immediately after entering into the group of transactions? Should we permit a fund to engage in derivatives transactions that reduce the fund's exposure, even if the reduced exposure still exceeds the applicable exposure limit? Could funds use such a provision to maintain exposure amounts in excess of the rule's limits for long periods of time? Could we address that concern by, for example, permitting a fund to engage in these exposure-reducing derivatives transactions provided that the fund brings its exposure below the applicable limit within a specified period of time, like thirty days?

### C. Asset Segregation Requirements for Derivatives Transactions

In addition to requiring funds to comply with one of two alternative portfolio limitations designed to impose a limit on the amount of leverage a fund could obtain through derivatives transactions and other senior securities transactions as described in section III.B.1.c above, the proposed rule would require a fund that enters into derivatives transactions in reliance on the rule to manage the risks associated with its derivatives transactions by maintaining an amount of certain assets (defined in the proposed rule as "qualifying coverage assets") designed to enable the fund to meet its obligations arising from such transactions.[321] This requirement is designed to address the asset sufficiency concern reflected in section 1(b)(8) of the Act.[322] In addition, the asset segregation requirement in the proposed rule would help to address the undue speculation concern reflected in section 1(b)(7) of the Act to the extent that funds limit their derivatives usage in order to comply with the asset segregation requirements.[323]

To rely on the proposed rule, a fund would be required to manage the risks associated with its derivatives transactions by maintaining a certain amount of qualifying coverage assets for each derivatives transaction, determined pursuant to policies and procedures approved by the fund's board of directors.[324] For each derivatives transaction, a fund would be required to maintain qualifying coverage assets with a value equal to the amount that would be payable by the fund if the fund were to exit the derivatives transaction as of the time of determination and an

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321 Proposed rule 18f-4(a)(2), (c)(6), (c)(8), (c)(9).

322 *See* section 1(b)(8) of the Investment Company Act. The asset segregation requirements in the proposed rule also are based in part on the considerations that informed our guidance in Release 10666 that maintaining assets in the segregated account would help "assure the availability of adequate funds to meet the obligations" arising from the trading practices described in that release. *See* Release 10666, *supra* note 20, at n.8.

323 *See* section 1(b)(7) of the Investment Company Act. Under the proposed rule, a fund would be required to maintain a certain amount of qualifying coverage assets—which generally would be required to be cash and cash equivalents—with respect to its derivatives transactions. A fund could determine not to enter into derivatives transactions that would otherwise be permitted under the proposed rule's exposure limits in order to avoid having to maintain qualifying coverage assets for the transactions. In addition, under certain circumstances, the asset segregation requirements could limit a fund's ability to enter into a derivatives transaction that would otherwise be permitted under the proposed rule's exposure limits because the fund does not have and is unable to acquire sufficient qualifying coverage assets to comply with the proposed rule. The proposed rule also would address concerns about leverage directly, though the proposed rule's portfolio limitations discussed in section V.B.1.

324 *See* proposed rule 18f-4(a)(2), (a)(5)(ii), (c)(6), (c)(8), (c)(9).

additional amount that represents a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions.[325]

Qualifying coverage assets for derivatives transactions would need to be identified on the books and records of the fund at least once each business day.[326] With certain exceptions, the proposed rule would define qualifying coverage assets for derivatives transactions to mean cash and cash equivalents because, as further described below, these assets are extremely liquid and may be less likely to experience volatility in price or decline in value in times of stress than other types of assets.[327] The proposed rule, by requiring a fund to hold a sufficient amount of these types of assets, is designed to enable the fund to meet its obligations under its derivatives transactions.[328]

The proposed rule's approach to asset segregation is designed to provide a flexible framework that would allow funds to apply the requirements of the proposed rule to particular

325 Proposed rule 18f-4(a)(2), (c)(6), (c)(8), (c)(9).

326 Proposed rule 18f-4(a)(2).

327 *See* proposed rule 18f-4(c)(8); *infra* note 369 and accompanying text. The exceptions to the requirement to maintain cash and cash equivalents, discussed below, are for derivatives transactions under which a fund may satisfy its obligation by delivering a particular asset, in which case that particular asset would be a qualifying coverage asset. *See* proposed rule 18f-4(c)(8).

328 We note that, pursuant to proposed rule 22e-4, funds subject to that rule would be required to consider, in assessing the liquidity of a position in a particular portfolio asset, whether the fund invests in the asset because it is connected with an investment in another portfolio asset. *See* proposed rule 22e-4(b)(2)(ii)(I). As explained in more detail in the Liquidity Release, assets segregated to cover derivatives and other transactions would be classified, for purposes of rule 22e-4, using the liquidity of the transaction they are covering because such assets would only be available for sale to meet fund redemptions once the related transaction is disposed of or unwound. *See* Liquidity Release, *supra* note 5, at section III.B.2. Thus, for purposes of proposed rule 22e-4, the liquidity of qualifying coverage assets segregated pursuant to proposed rule 18f-4 to cover derivatives transactions would be classified using the liquidity of the corresponding derivatives transactions. Similarly, the liquidity of qualifying coverage assets segregated pursuant to proposed rule 18f-4 to cover a financial commitment transaction would be classified using the liquidity of the corresponding financial commitment transaction.

derivatives transactions used by funds at this time as well as those that may be developed in the future as financial instruments and investment strategies change over time. As discussed in more detail below, the proposed rule's approach to asset segregation is designed to provide this flexibility by requiring funds to determine the amount of qualifying coverage assets in a way that can be applied by funds to various types of transactions and by permitting these amounts to be determined in accordance with board-approved policies and procedures. The proposed rule's approach to asset segregation also is consistent with the views expressed by many commenters on the Concept Release, as discussed below.[329]

We believe that requiring the fund's board to approve the policies and procedures for asset segregation, including a majority of the fund's independent directors, appropriately would focus the board's attention on the fund's management of its obligations under derivatives transactions and the fund's use of the exemption provided by the proposed rule. We believe that requiring the fund's board to approve these policies and procedures, in conjunction with the board's oversight of the fund's investment adviser more generally, would be an appropriate role for the board.[330]

### *1. Coverage Amount for Derivatives Transactions*

Under the proposed rule, a fund would be required to manage the risks associated with its derivatives transactions by maintaining qualifying coverage assets for each derivatives transaction in an amount equal to the sum of (1) the amount that would be payable by the fund if the fund were to exit the derivatives transaction at the time of determination (the "mark-to-

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329 *See infra* note 332.

330 Other exemptive rules under the Act similarly require the fund's board to take certain actions in order for the fund to rely on the exemption provided by the rule. *See, e.g.*, rules 18f-3, 17a-7, 10f-3, and 2a-7.

market coverage amount"), and (2) a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions (the "risk-based coverage amount").[331] The proposed rule's asset coverage requirements reflect that, although a fund will be able to determine its current mark-to-market payable under a derivatives transaction on a daily basis, the fund's investment in the derivatives transaction can involve future losses, and thus potential payments by the fund to counterparties, that will depend on future changes related to the derivative's reference asset or metric.

The proposed rule's asset coverage requirements for derivatives transactions also are consistent in many respects with the approach suggested by many commenters to the Concept Release.[332] These commenters suggested that, for derivatives transactions, a fund should segregate its daily mark-to-market liability as well as an additional amount, sometimes referred to as a "cushion" by commenters, designed to address future potential losses.

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331 Proposed rule 18f-4(a)(2), (c)(6), (c)(9).

332 *See, e.g.*, ICI Concept Release Comment Letter, at 11 ("The optimal amount of cover for many instruments may be somewhere in between full notional and mark to market amounts. It should be an amount expected to cover the potential loss to the fund, determined with a reasonably high degree of certainty. This amount—mark-to-market plus a 'cushion'—is more akin to the way portfolio officers and risk managers assess the portfolio risks created through the use of derivatives."); SIFMA Concept Release Comment Letter, at 4 ("...the AMG recommends that the Commission formulate a standard for asset segregation that would be calculated as the sum of (i) the current mark-to-market value of the derivative (representing the indebtedness on the instrument), *plus* (ii) a 'cushion' amount that would reflect potential future indebtedness); Comment Letter of AlphaSimplex Group, LLC on Concept Release (Nev. 7, 2011) (File No. S7-33-11) ("AlphaSimplex Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-41.pdf, at 5 ("So long as the derivative in question has daily liquidity and daily margin calls...a fund may segregate assets equal to the sum of the daily marked-to-market obligation of the fund plus an allowance for some daily price move that could increase the fund's outstanding obligations..."); BlackRock Concept Release Comment Letter, at 5 ("Under a principles-based approach, the amount that would need to be segregated is the net payment amount to which the fund is potentially exposed under plausible scenarios, plus a risk premium."); Vanguard Concept Release Comment Letter, at 7 ("In our view, a fund's potential future exposure is the market value of the derivative (calculated daily) plus an additional amount that takes into account the derivative's potential intra-day price changes based on its volatility during reasonably foreseeable market conditions.").

*a. Mark-to-Market Coverage Amount*

Under the proposed rule, the "mark-to-market coverage amount" for a particular derivatives transaction, at any time of determination, would be equal to the amount that would be payable by the fund if the fund were to exit the derivatives transaction at such time.[333] We expect that the mark-to-market coverage amount generally would be consistent with a fund's valuation of a derivatives transaction because the amount of a fund's mark-to-market coverage amount would generally correspond to the amount of the fund's liability with respect to the derivatives transaction.[334] The proposed rule's requirement that the fund manage the risks associated with its derivatives transactions by maintaining qualifying coverage assets with a value equal to the fund's mark-to-market coverage amount thus is designed to require the fund to have assets sufficient to meet its obligations under the derivatives transaction, which may include margin or similar payments demanded by the fund's counterparty as a result of mark-to-market losses, or payments that the fund may make in order to exit the transaction. A fund would be

[333] Proposed rule 18f-4(c)(6). In some cases the fund would not be required to make any payments if the fund were to exit the derivatives transaction, such as where the fund invested in a swap that appreciates in value and the fund determines that it would receive a payment if it were to exit the transaction at that time. In this case the mark-to-market coverage amount would be equal to zero, but the fund would still be required to consider the risk-based coverage amount for such transaction, as discussed below. The mark-to-market coverage amount should reflect any accrued but unpaid premiums or other similar periodic payments owed under the derivatives transaction, as these amounts would influence the amount the fund would pay if it were to exit the derivatives transaction.

[334] We believe that the mark-to-market coverage amount also would generally be consistent with the practices of funds that segregate the mark-to-market liability associated with a derivatives transaction. *See, e.g.*, Rafferty Concept Release Comment Letter, at 12 ("For example, because the swap transactions in which the Direxion Trusts engage are fully cash settled, the Direxion Trusts segregate: (1) the amount (if any) by which the swap is out of the money to the fund (*i.e.*, the estimated amount that the fund would be required to pay upon an early termination, hereinafter referred to as the "fund's out of the money amount"), marked-to-market daily, plus (2) the amount of any accrued but unpaid premiums or similar periodic payments, net of any accrued but unpaid periodic payment payable by the counterparty."); Loomis Concept Release Comment Letter (indicating that the mark-to-market value of the derivative contract covers "the amount of the unrealized gain or loss on the transaction").

required to calculate the mark-to-market coverage amount at least once each business day under the proposed rule in order to provide the fund with a reasonably current estimate of the amount that may be payable by the fund with respect to the derivatives transaction.[335]

For example, if a fund has a swap position that has moved against the fund (i.e., decreased in value) as a result of a change in the market value of the underlying reference asset, the fund's mark-to-market coverage amount would generally be equal to the fund's liability with respect to the swap because that would be the amount payable by the fund if the fund were to exit the swap at that time. The mark-to-market coverage amount thus would reflect the amount that would be payable by the fund based on market values and conditions existing at the time of determination. We understand that in many cases funds can readily calculate such amounts because they are already calculating their liability under the derivatives transaction for purposes of determining their net asset value, and that such mark-to-market amounts may reflect the amounts that would be payable by the fund at such time if the fund were to exit the derivatives transaction due to a default or pursuant to other actions by the fund, such as a negotiated agreement with the fund's counterparty, a transfer to another party, or a close out of the position through execution of an offsetting transaction.

As another example, if a fund has written an option, it will generally have received a premium payment that would represent the option's fair value at that time. The amount of the premium initially received by the fund for writing the option thus would represent the fund's mark-to-market coverage amount at the inception of the transaction because it would represent

[335] Proposed rule18f-4(a)(2). We expect that funds would calculate their mark-to-market coverage amount as part of their determination of their net asset value, for those funds that calculate their net asset value each day. In addition, although the proposed rule does not require a fund to calculate the mark-to-market coverage amount more than once each business day, a fund may determine to calculate this amount more frequently.

the amount that would be payable by the fund at that time if the fund were to exit the transaction (in this case, by purchasing an offsetting option).[336] The fund generally would be able to satisfy the proposed rule's requirement to maintain qualifying coverage assets with a value equal to the fund's mark-to-market coverage amount at the inception of the trade by maintaining the premium it received for writing the option because the mark-to-market coverage amount, at that time, would generally equal the amount of such premium received. If the option moved against the fund, however, the amount that would be payable by the fund if the fund were to exit the transaction would increase, and this increased amount would represent the fund's mark-to-market coverage amount.

Under the proposed rule, if a fund has entered into a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions, the mark-to-market coverage amount for all derivatives transactions covered by the netting agreement could be calculated on a net basis, to the extent such calculation is consistent with the terms of the netting agreement.[337] This aspect of the proposed rule thus is designed so that the mark-to-market coverage amount more accurately reflects the fund's current net amounts payable with

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336 *See, e.g.*, Options Clearing Corporation, *Understanding Stock Options* (1994), *available at* http://www.cboe.com/learncenter/pdf/understanding.pdf, at 8 (noting that the holder or writer of an exchange-traded option "can close out his position at any time simply by making an offsetting, or closing, transaction" which "cancels out an investor's previous position as the holder or writer of the option").

337 Proposed rule 18f-4(c)(6)(i). Under the proposed rule, the total amount of a fund's qualifying coverage assets must equal at least the sum of the fund's aggregate mark-to-market coverage amounts and risk-based coverage amounts. Proposed rule 18f-4(a)(2). Thus, qualifying coverage assets could not be used to cover more than one derivatives transaction unless the transactions are subject to a netting agreement and the fund calculates its coverage amounts with respect to such transactions on a net basis. In addition, qualifying coverage assets used to cover a derivatives transaction could not also be used to cover a financial commitment transaction. Proposed rule 18f-4(c)(8).

respect to the derivatives transactions covered by such netting agreements.[338] The proposed rule would only allow a fund to net derivatives transactions for purposes of determining mark-to-market coverage if the fund has a netting agreement that allows the fund to net its payment obligations with respect to such transactions because, absent such an agreement, the fund generally would not have the right to net its payment obligations and could be required to tender the full amount payable under all of its derivatives transactions.

The proposed rule would also allow a fund to reduce the mark-to-market coverage amount for a derivatives transaction by the value of any assets that represent variation margin or collateral to cover the fund's mark-to-market loss with respect to the transaction.[339] This aspect of the proposed rule would allow a fund to receive credit for assets that the fund posts to cover the fund's current obligations under the derivatives transaction, and which would be applied as security for, or to satisfy, those obligations under the derivatives transaction.[340] For example, if a fund that has entered into an OTC swap and has delivered collateral equal to its mark-to-market loss on the OTC swap, the fund generally would not also be required to segregate qualifying coverage assets with respect to the swap's mark-to-market coverage amount, because the

338 *See also* section III.D.

339 Proposed rule 18f-4(c)(6)(ii).

340 The custody of fund assets is regulated by section 17(f) of the Act and the rules thereunder. Section 17(f) generally requires a fund to place and maintain its securities and similar investments in the custody of a qualified custodian of the type specified in section 17(f) and the rules thereunder. When we refer in this Release to assets being "posted" or "delivered," as margin or collateral, we are referring to a fund's posting or delivering those assets in compliance with the requirements of section 17 and the rules thereunder. We understand, for example, that in order to comply with these requirements in respect of non-centrally cleared OTC derivatives, funds generally do not deliver collateral directly to their counterparties, but instead hold posted collateral in a custody account (maintained with the fund's bank custodian) that is administered pursuant to a tri-party control agreement among the fund, its custodian and its counterparty, under which the counterparty maintains a security interest in the collateral, but may only have access to the collateral in the event of a fund's default.

collateral delivered would equal the amount payable by the fund, based on market conditions, if the fund were to exit the transaction at that time. As another example, if a fund that has invested in a futures contract posts variation margin to settle its daily margin obligations under the futures contract, the fund would not be required to also segregate qualifying coverage assets under the proposed rule to cover this same mark-to-market amount under the proposed rule.[341]

In order to reduce the mark-to-market coverage amount, the assets must represent variation margin or collateral to cover the mark-to-market exposure of the transaction. Thus, initial margin (sometimes referred to as an "independent amount" with respect to certain OTC derivatives transactions) would not reduce the fund's mark-to-market coverage amount with respect to the derivatives transaction because initial margin represents a security guarantee to cover potential future amounts payable by the fund and is not used to settle or cover the fund's mark-to-market exposure.[342] Initial margin amounts would not be expected to be available to satisfy the fund's variation margin requirements under a derivatives contract absent a default by the fund—and thus the fund would need additional assets to cover these mark-to-market

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341 Depending on the rules of the applicable futures exchange and local law, a variation margin payment with respect to a futures transaction may be deemed to settle the fund's liability for the daily mark-to-market loss on the futures transaction, and such a payment once made would also eliminate the fund's liability under the futures transaction. A fund that paid variation margin to settle the full amount of its mark-to-market loss on a futures transaction would not, at that time, have to pay any additional amount if the fund were to exit the transaction. If, at the time the fund determines its mark-to-market coverage amount, the fund would be required to pay an additional amount in excess of variation margin to exit the futures transaction, then the fund would need to have qualifying coverage assets in respect of such additional amount in order to comply with the mark-to-market coverage requirement.

342 If the fund has posted variation margin or collateral in excess of its current liability under the derivatives transaction, such excess amount would not under the proposed rule reduce the fund's mark-to-market coverage amount for other derivatives transactions, except as otherwise permitted under a netting agreement as described above.

payments—notwithstanding that the fund had previously posted initial margin with respect to such derivatives transaction.[343]

We expect that funds will be readily able to determine their mark-to-market coverage amounts because they are already engaging in similar calculations on a daily basis. For example, as described in more detail in section II.D.1 above, funds today are determining their current mark-to-market losses, if any, each business day with respect to the derivatives for which they currently segregate assets on a mark-to-market basis.[344] Funds also already calculate their liability under derivatives transactions on a daily basis for various other purposes, including to satisfy variation margin requirements and to determine the fund's NAV. Funds also calculate their liability under derivatives transactions on a periodic basis in order to provide financial statements to investors. We generally expect that funds would be able to use these calculations to determine their mark-to-market coverage amounts.

We request comment on all aspects of the proposed rule's requirements concerning the mark-to-market coverage amount.

- Is the definition of "mark-to-market coverage amount" sufficiently clear? Are there any derivatives transactions for which the definition of mark-to-market coverage amount would not provide an appropriate calculation of the amounts payable by the fund if the fund were to exit the transaction? Are there types of derivatives transactions for which funds may not be able to determine a mark-to-market coverage amount at least once each business day as proposed?

343 The proposed rule would, however, allow a fund to reduce a derivative's risk-based coverage amount by the value of assets posted as initial margin, as discussed below.

344 *See supra* section II.D.1.

- Although we have not incorporated accounting standards with respect to the determination of mark-to-market coverage amount in the proposed rule, the mark-to-market coverage amount generally would be consistent with a fund's valuation of a derivatives transaction, as noted above. Should we instead define a fund's mark-to-market coverage amount based on accounting standards? Should we, for example, define the term mark-to-market coverage amount to mean the amount of the fund's liability under the derivatives transaction? Would this approach result in mark-to-market coverage amounts that would differ from mark-to-market coverage amounts determined as proposed? If so, how would they differ? If we were to define a fund's mark-to-market coverage amount based on accounting standards, are there adjustments to these accounting standards that we should make for purposes of the proposed rule?
- The proposed rule would allow a fund to determine its net mark-to-market coverage amount for multiple derivatives transactions if a fund has entered into a netting agreement that allows the fund to net its payment obligations for the transactions. Is this appropriate? Should we impose further limitations on a fund's ability to net transactions, including, for example, prohibiting netting across asset classes or across different types of derivatives? Should we, in contrast, permit netting more extensively? Are there other situations in which funds today net their obligations with derivatives counterparties that would not be permitted under the proposed rule and for which funds believe netting would be appropriate? Should we include specific parameters in the rule regarding the enforceability of the agreement in a bankruptcy or similar proceeding?

- The proposed rule would allow a fund to reduce its mark-to-market coverage amount by the value of assets that represent variation margin or collateral. Is this appropriate? Should we instead restrict this provision to variation margin or collateral that meets certain minimum requirements (e.g., cash, cash equivalents, high-quality debt securities)? Should we permit the fund to reduce its mark-to-market coverage for initial margin?
- Should we permit a fund to reduce its mark-to-market coverage amount in circumstances not involving netting or posting of margin or collateral? Should we, for example, permit funds to reduce their mark-to-market coverage amount for a derivatives transaction to reflect gains in other transactions that the fund believes would mitigate such losses? If we were to permit a fund to reduce its mark-to-market coverage amount in these circumstances, what limitations should we impose to assure that a fund would have liquid assets to meet its obligations under a particular derivatives transaction if a counterparty to a potentially mitigating transaction were to default on its obligation to the fund or that transaction did not perform in a way that would mitigate such losses?
- As noted above, we believe that many funds will be readily able to determine their mark-to-market coverage amounts because they today are determining their liability, if any, each business day with respect to the derivatives for which they apply mark-to-market segregation or for other purposes. Should the mark-to-market coverage amount be determined more than once per day? Is once per day too frequent? Should we require funds to make this determination at the same time they determine their NAV? Should closed-end funds or BDCs or both be

subject to different requirements? If we were to permit closed-end funds or BDCs or any other fund to determine their mark-to-market coverage amounts less frequently, what additional limitations, if any, should we impose to assure that the funds would have liquid assets to meet their obligations under derivatives transactions?

*b. Risk-Based Coverage Amount*

As discussed above, the mark-to-market coverage amount generally represents the amount that would be payable by the fund if the fund were to exit the derivatives transaction at such time. The fund's payment obligations under a derivatives transaction could vary significantly over time, however, potentially resulting in a significant gap between the mark-to-market coverage amount, if any, and the fund's future payment obligations under the derivatives transaction.[345] The mark-to-market coverage amount, if any, may thus be substantially smaller than the potential amounts payable by the fund in the future under the derivatives transaction.[346] We observed the argument in the Concept Release that segregating only the mark-to-market liability "may understate the risk of loss to the fund"[347] and many commenters suggested that we require funds to segregate assets in addition to a derivative's mark-to-market liability.[348]

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345 *See*, *e.g.*, The Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) ("2010 ABA Derivatives Report"); SIFMA Concept Release Comment Letter.

346 Moreover, there may be no mark-to-market coverage amount if, as a result of the appreciation of a derivatives transaction, the fund would not be required to make a payment (but rather would receive a payment from its counterparty) if the fund were to exit the derivatives transaction at such time.

347 *See* Concept Release, *supra* note 3, at n.83.

348 *See supra* note 332.

Because the fund's mark-to-market coverage amount for a derivatives transaction would not reflect the potential amounts payable by the fund in the future under the derivatives transaction, the proposed rule would require a fund to segregate an additional amount called the "risk-based coverage amount" that would represent a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions.[349] A fund would be required to determine this amount at least once each business day, consistent with the timing applicable to the calculation of the mark-to-market coverage amount as described above, in order to provide the fund with a reasonably current estimate of the potential amounts payable under the derivatives transaction, based on the current market values and conditions existing at the time the fund makes this determination.

This risk-based coverage requirement in the proposed rule is consistent with the views expressed by several commenters to the Concept Release that funds should segregate, not only their current liability under the contract, but also an additional amount meant to cover future losses.[350] Several commenters recognized that a fund may be obligated to make future payments in excess of its current liabilities under a derivatives transaction.[351] For example, one commenter stated that funds should "segregate not just the mark-to-market value, but also an additional amount calculated using a measure of potential future losses."[352] Another commenter also noted that requiring funds to segregate a mark-to-market amount under the contract as well as an

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349 Proposed rule 18f-4(a)(2), (c)(9).

350 *See*, *e.g.*, ICI Concept Release Comment Letter, *supra* note 8; Comment Letter of the Asset Management Group of the Securities Industry and Financial Markets Association (Nov. 23, 2011) (File No. S7-33-11).

351 *See* SIFMA Concept Release Comment Letter; ICI Concept Release Comment Letter; Loomis Sayles Concept Release Comment Letter; BlackRock Concept Release Comment Letter.

352 *See* SIFMA Concept Release Comment Letter.

additional amount meant to cover future losses "is more akin to the way portfolio managers and risk officers assess the portfolio risks created through the use of derivatives."[353]

Under the proposed rule, the risk-based coverage amount for each derivatives transaction would be determined in accordance with policies and procedures approved by the fund's board of directors.[354] By requiring funds to establish appropriate policies and procedures, rather than prescribing specific segregation amounts or methodologies, the proposed rule is designed to allow funds to assess and determine risk-based coverage amounts based on their specific derivatives transactions, investment strategies and associated risks. We expect that funds may be best situated to evaluate and determine the appropriate risk-based coverage amount for each of their derivatives transactions based on a careful assessment of their own particular facts and circumstances.

We believe an approach to asset segregation that is based, in part, on a fund's assessment of its own particular facts and circumstances would be more appropriate than a requirement to segregate only a fund's mark-to-market liability, on one hand, or the full notional amount, on the other. As we noted in the Concept Release, "both notional amount and a mark-to-market amount have their limitations."[355] A fund's segregation only of any mark-to-market liability, if any, may not effectively assure the fund will have sufficient assets to meet its obligations under the derivatives transaction for the reasons we discuss above in section II.D.1.c. A fund's segregation of the full notional amount for all of its derivatives transactions, in contrast, could in some cases require funds to hold more liquid assets than may be necessary to address the investor protection

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353 *See* ICI Concept Release Comment Letter.

354 Proposed rule 18f-4(a)(2), (a)(5), (c)(9).

355 *See* Concept Release, *supra* note 3, at n.27.

purposes and concerns underlying section 18 because the notional amount of a derivatives transaction does not necessarily equal, and often will exceed, the amount of cash or other assets that fund ultimately would likely be required to pay or deliver under the derivatives transaction. The proposed rule seeks to address these concerns, which also were shared by commenters on the Concept Release, by requiring a fund to segregate the mark-to-market and risk-based coverage amounts associated with its derivatives transactions.

Under the proposed rule, a fund's policies and procedures for determining the risk-based coverage amount for each derivatives transaction would be required to take into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset.[356] The fund's risk-based coverage amount for a derivatives transaction, therefore, would be an amount determined in accordance with the fund's policies and procedures that takes into account these and any other relevant factors in determining a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions. This may include, for example, consideration of the fund's ability to terminate the trade or otherwise exit the position under stressed conditions, which could include an assessment of the derivative's terms and the fund's intended use of the derivative in connection with its investment strategy. We note that, if a fund has a derivatives transaction that is not traded or has an underlying reference asset that is not traded (or, in either case, is not traded on a regular basis) or the fund does not have the ability to terminate the transaction, then a fund's policies and procedures should consider whether the risk-based coverage amount should, in certain circumstances, be increased to reflect the full potential amount that may be payable by the fund under the derivatives transaction. In any case, the risk-based coverage amount must be

356 Proposed rule 18f-4(c)(9).

a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions, regardless of whether the fund is currently required to make such payments under the terms of the derivatives contract.

The requirements that we are proposing with respect to a fund's determination of the risk-based coverage amount are intended to permit a fund to tailor its procedures for determining the risk-based coverage amount to respond to the particular risks and circumstances associated with a fund's derivatives transactions. In developing policies and procedures to determine the risk-based coverage amount, a fund could use one or more financial models to determine the risk-based coverage amount, provided that the calculation reflects a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions and takes into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset, as required by the proposed rule. These tools may be useful in estimating the potential amounts payable by the fund under certain derivatives transactions, and may be an efficient way for a fund to determine the risk-based coverage amount for its derivatives, particularly for those funds that already use such methods for other purposes.

For example, as discussed in section III.D.2 below, a fund's policies and procedures under its derivatives risk management program could include stress testing. A fund that uses stress testing could consider using this approach to estimate the potential amount payable by the fund to exit a derivatives transaction by estimating the effects of various adverse events. Alternatively, a fund's policies and procedures could provide that, for a particular type of derivatives transaction, the fund's adviser would use a stressed VaR model to estimate the potential loss the fund could incur, at a given confidence level, under stressed conditions.[357]

As noted above, a fund's policies and procedures for determining its risk-based coverage amount would be required to take into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset. In calculating its risk-based coverage amount, a fund may take into account considerations in addition to these factors. For example, if a fund elects to conduct stress testing for other purposes and such stress tests incorporate factors other than those specified under the proposed rule, the fund should consider incorporating the results of this stress testing into the determination of its risk-based coverage amount.

As with the calculation of mark-to-market coverage amounts, if the fund has entered into a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions, the proposed rule would allow a fund to calculate its risk-based coverage amount on a net basis for all derivatives transactions covered by the netting agreement, in accordance with the terms of the netting agreement.[358] This aspect of the proposed rule is designed to recognize that if a fund has a netting agreement in effect, the potential amounts payable by the fund under a derivatives transaction covered by such agreement could be reduced by any future payments owed to the fund under other derivatives transactions covered by the

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357 Stressed VaR refers to a VaR model that is calibrated to a period of market stress. As noted in section III.B.2.a, a concern that has been recognized with VaR is that it may not adequately reflect "tail risks," i.e., the size of losses that may occur on the trading days on which the greatest losses occur, and that VaR may underestimate the risk of loss under stressed market conditions. However, by calibrating VaR to a period of market stress, stressed VaR may better reflect the potential losses that a fund could incur through a derivatives transaction, and thus serve as an appropriate method for determining a reasonable estimate of the potential amount payable by the fund if the fund were to exit the transaction under stressed conditions.

358 Proposed rule 18f-4(c)(9)(i).

netting agreement, with the fund being required to pay only the net amount. Thus, the proposed rule would allow the fund to calculate its risk-based coverage amount for all derivatives transactions covered by the netting agreement on a net basis. For example, if a fund has two derivatives transactions that are covered by a netting agreement, and one of the transactions is inversely correlated with the other position, the fund could determine its risk-based coverage amount for both derivatives transactions on a net basis, taking into account anticipated gains that it reasonably expects may reduce potential amounts payable by the fund under stressed conditions under other derivatives transactions covered by the same netting agreement. The proposed rule would only allow a fund to net derivatives transactions for purposes of determining risk-based coverage if the fund has a netting agreement that allows the fund to net its payment obligations with respect to such transactions because, absent such an agreement, the fund may not have the right to reduce its payment obligations and could potentially be required to tender the full amount payable under each derivatives transaction.

The proposed rule would also allow a fund to reduce the risk-based coverage amount for a derivatives transaction by the value of any assets that represent initial margin or collateral in respect of such derivatives transaction.[359] This would allow a fund to receive credit for assets that are already posted as a security guarantee to cover potential future amounts payable by the fund under the derivatives transaction, and which could ultimately be used by the fund's counterparty to satisfy those obligations if needed. In order to reduce the risk-based coverage amount, the assets must represent initial margin or collateral to cover the fund's future potential amounts payable by the fund under the derivatives transaction.[360] Further, initial margin or

359 Proposed rule 18f-4(c)(9)(ii).

360 Assets that represent variation margin are used to satisfy the fund's current mark-to-market

collateral can only reduce the risk-based coverage amount for the specific derivatives transaction for which such assets were posted.[361]

The proposed rule therefore would give a fund credit for initial margin by not requiring the fund to maintain risk-based coverage assets in respect of future amounts payable that could be satisfied by the fund's initial margin. We believe that giving a fund credit for initial margin in this way is more appropriate than an approach suggested by at least one commenter under which we would provide that a fund's "cushion" would be equal to the required initial margin for a particular transaction.[362] Final rules regarding the margin requirements for OTC swaps have not been adopted by all federal agencies, and we note that not all funds may be required to post initial margin for their OTC swaps under those rules.[363] Therefore, while these margin

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liability under the derivatives transaction and would not be available to cover the fund's potential future liabilities under the transaction. Thus, assets that represent variation margin would not reduce the fund's risk-based coverage amount with respect to the derivatives transaction. We believe it is appropriate to count only initial margin given that the risk-based coverage amount is designed to cover potential future amounts payable by the fund.

361 The proposed rule requires the fund to calculate risk-based coverage amounts on a transaction-by-transaction basis in respect of each of the fund's derivatives transactions. Assets delivered as collateral for a particular derivatives transaction thus cannot be used to cover other derivatives transactions unless the transactions are covered by a netting agreement. In the event that a fund posts initial margin or collateral to cover multiple derivatives transactions, the risk-based coverage amount for all derivatives transactions covered by such initial margin or collateral cannot be reduced by more than the total amount of the initial margin or collateral.

362 *See* SIFMA Concept Release Comment Letter.

363 *See* Prudential Regulator Margin and Capital Adopting Release, *supra* note 160; CFTC Margin Proposing Release, *supra* note 160; *cf.* 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 (Nov. 23, 2012)] ("Margin and Capital Proposing Release"). Under rules adopted by the banking regulators and rules proposed by the CFTC, initial margin may be calculated using either an internal models approach (under which initial margin would be calculated using an approved model calibrated to a period of stress conditions) or a standardized initial margin approach (under which initial margin would be calculated using a standardized initial margin schedule). Under these rules, however, not all funds would be required to post initial margin. For example, under rules adopted by the banking regulators, a covered swap entity, such as a bank, would only be required to collect initial margin from a swap counterparty, such as a fund, if the fund has

requirements may provide benchmarks that may assist a fund in the evaluation of risk-based coverage amounts, they do not appear to provide a means of implementing a risk-based coverage amount requirement for all funds that engage in the use of derivatives.[364]

A fund could, however, consider any applicable initial margin requirements when determining its risk-based coverage amount for a derivatives transaction. But if a fund determines that its risk-based coverage amount—that is, a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions—is greater than the initial margin the fund would be required to post, the fund would need to maintain qualifying coverage assets equal to such greater amount in order to comply with the proposed rule.

We request comment on all aspects of the proposed rule's requirement that a fund manage the risks associated with its derivatives transactions by maintaining qualifying coverage assets equal to the fund's aggregate risk-based coverage amounts for its derivatives transactions.

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"material swaps exposure," which is a threshold under the rule that would apply if a fund and its affiliates have average daily aggregate notional exposure from swaps, security-based swaps, foreign exchange forwards, and foreign exchange swaps that exceeds $8 billion. *See* Prudential Regulator Margin and Capital Adopting Release, *supra* note 160. The rules proposed by the CFTC have a similar threshold and would only require a covered swap entity to collect initial margin from a swap counterparty, such as a fund, if the fund has material swaps exposure that exceeds $3 billion. *See* CFTC Margin Proposing Release, *supra* note 160. Thus, these rules would generally only require a fund to post initial margin if the fund has average daily exposure to swaps in excess of $8 billion or $3 billion. *See* Prudential Regulator Margin and Capital Adopting Release, *supra* note 160; CFTC Margin Proposing Release, *supra* note 160. (The initial margin rules proposed by the Commission for uncleared security-based swaps do not impose minimum thresholds for the collection of initial margin. *See* Margin and Capital Proposing Release, *supra*).

364 *See* Prudential Regulator Margin and Capital Adopting Release, *supra* note 160; CFTC Margin Proposing Release, *supra* note 160.

- Is the definition of risk-based coverage amount sufficiently clear to allow a fund to develop policies and procedures to determine a risk-based coverage amount for all derivatives transactions?
- Rather than determining the risk-based coverage amount in accordance with policies and procedures approved by the board, should we prescribe risk-based coverage amounts in the proposed rule? Should we, for example, provide that the risk-based coverage amount must be determined based on a specific financial model (i.e., VaR at a particular confidence level)? Should we specify a percentage of the derivative's notional value? If so, what percentage should we choose? Should it vary for different types of derivatives? For example, should the proposed rule include a standardized schedule that specifies the risk-based coverage amount for particular derivatives transactions? If so, should the schedule be similar to, or different from, the standardized schedules under rules that have been proposed or adopted for swap entities that are required to collect initial margin and elect to use a standardized schedule approach instead of an internal model approach? If so, should the standardized schedule approach be in addition to, or in place of, the approach currently described in the proposed rule? Why or why not?
- Should we retain the proposed rule's approach that the risk-based coverage amount be determined in accordance with board-approved policies and procedures, but also provide funds the option to use certain prescribed standards for the calculation of the risk-based coverage amount? In other words, should the proposed rule prescribe a specific financial model or amount of the derivative's

notional amount that could be used by funds to determine the risk-based coverage amount without the need for additional policies and procedures? If so, which models or notional amounts should we specify? Should we provide, for example, that a fund may use as its risk-based coverage amount for a particular derivatives transactions the VaR calculated using a VaR model that meets the minimum criteria for a VaR model under the proposed rule and that provides stressed VaR estimates?

- Are there additional items that a fund should be required to consider when preparing policies and procedures in respect of the risk-based coverage amount?
- The risk-based coverage amount as proposed would be a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions. Is the term "stressed conditions" clear? If not, how could the term "stressed conditions" be made more clear? Is "stressed conditions" an appropriate standard? Is there an alternative standard that would be more appropriate? Should it be an estimate that does not involve stressed conditions?
- The proposed rule would allow a fund to net derivatives transactions for purposes of determining the risk-based coverage amount if a fund has a netting agreement in effect that would allow the fund to net its payment obligations for such transactions. Is this appropriate? Should we impose further limitations on a fund's ability to net transactions, including, for example, prohibiting netting across asset classes or different types of derivatives? Should we, in contrast, permit netting more extensively? Are there situations in which initial margin for

funds is calculated on a net basis that would not be permitted under the proposed rule and for which funds believe netting would be appropriate? Are there other situations in which funds today net their obligations with derivatives counterparties that would not be permitted under the proposed rule and for which funds believe netting would be appropriate? Should we include specific parameters in the rule regarding the enforceability of the agreement in a bankruptcy or similar proceeding?

- In situations not involving a netting agreement, should we allow a fund to reduce its risk-based coverage amount for a derivatives transaction to reflect anticipated or actual gains in other transactions that the fund believes are likely to produce gains for the fund at the same time as other derivatives experience losses? If so, what parameters or guidelines should we prescribe to address market risk, counterparty risk or other payment risks if netting is permitted under the proposed rule for these separate transactions?
- The proposed rule would allow a fund to reduce its risk-based coverage amount by the value of assets that represent initial margin or collateral. Is this appropriate? Should we instead restrict this reduction to initial margin or collateral that meets certain minimum requirements (*e.g.*, cash, cash equivalents, high-quality debt securities)? Should we, in contrast, give the fund more flexibility to reduce its risk-based coverage?
- Should we require the risk-based coverage amount to be calculated based expressly on initial margin requirements, rather than requiring funds to determine these amounts in accordance with policies and procedures, as proposed, which

could be informed by margin requirements? Should we require the risk-based coverage amount to be no less than the initial margin requirement, without regard to minimum transfer amounts or limits that would apply to a particular fund?

- Should we require any type of stress testing or back-testing with respect to the calculation of the risk-based coverage amount?
- Should the risk-based coverage amount be determined more than once per day? Is once per day too frequent?
- The risk-based coverage amount as proposed would generally be determined on an instrument-by-instrument basis (but would permit the fund to determine risk-based coverage amounts on a net basis in certain circumstances as discussed above). Should we, instead, permit or require funds to determine the risk-based coverage amount on a fund's entire portfolio? Alternatively, should we permit the risk-based coverage amount to be determined on a net basis with respect to particular subsets of the portfolio? For example, should we allow a fund to calculate separate risk-based coverage amounts for instruments that fall within different broad risk categories, such as equity, credit, foreign exchange, interest rate, and commodity risk? If so, how should funds calculate such risk-based coverage amounts? Would either of these approaches be more or less effective at assuring funds will have liquid assets to meet their obligations under their derivatives transactions? Would either of these approaches be more or less cost efficient for funds?

*2. Qualifying Coverage Assets*

As described above, the proposed rule would require a fund to manage the risks associated with its derivatives transactions by maintaining qualifying coverage assets, identified on the books and records of the fund and determined at least once each business day, in respect of each derivatives transaction. Under the proposed rule, "qualifying coverage assets" in respect of a derivatives transaction would be fund assets that are either: (1) cash and cash equivalents; or (2) with respect to any derivatives transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset. The total amount of a fund's qualifying coverage assets could not exceed the fund's net assets.[365]

#### *a. Cash and Cash Equivalents*

Under the proposed rule, a fund would generally be required to segregate cash and cash equivalents as qualifying coverage assets in respect of its coverage obligations for its derivatives transactions.[366] Current U.S. generally accepted accounting principles define cash equivalents as short-term, highly liquid investments that are readily convertible to known amounts of cash and that are so near their maturity that they present insignificant risk of changes in value because of changes in interest rates.[367] Examples of items commonly considered to be cash equivalents include certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds.[368]

365 Proposed rule 18f-4(c)(8).

366 Proposed rule 18f-4(c)(8). The proposed rule would not require funds to place qualifying coverage assets in a separate segregated account. In this Release when we refer to assets that a fund would "segregate" under the proposed rule, these are assets that the fund would identify as qualifying coverage assets on the fund's books and records determined at least once each business day, as noted above.

367 FASB Accounting Standards Codification paragraph 305-10-201; *see also* Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014) [79 FR 47736 (Aug. 14, 2014)] ("2014 Money Market Fund Reform Adopting Release"), at sections III.A.7 and III.B.6 (clarifying that the reforms to the regulation of money market funds adopted by the Commission in 2014 should not preclude an investment in a money market fund from being classified as a cash equivalent under U.S. GAAP under normal circumstances).

368 *See* Liquidity Release, *supra* note 5; FASB Accounting Standards Codification paragraph 305-10-201; Form PF: Glossary of Terms (defining "cash and cash equivalents").

We believe that cash and cash equivalents are appropriate qualifying coverage assets for derivatives transactions because these assets are extremely liquid because they are cash or could be easily and nearly immediately converted to known amounts of cash without a loss in value.[369] Other types of assets, in contrast, may be more likely to experience volatility in price or to decline in value in times of stress, even if subject to a haircut. We are not proposing to include as qualifying coverage assets other types of assets, such as equity securities or other debt securities, because we are concerned about the risk that such assets could decline in value at the same time the fund's potential obligations under the derivatives transactions increase, thus increasing the possibility that such assets could be insufficient to cover the fund's obligations under derivatives transactions. In addition, we understand that cash and cash equivalents are commonly used for posting collateral or margin for derivatives transactions. For example, ISDA reported in a 2015 survey that cash represented 77% of collateral received for uncleared derivatives transactions (with government securities representing an additional 13% percent), while for cleared OTC transactions with clients, cash represented 59% of initial margin received (with government securities representing an additional 39%) and 100% of variation margin received.[370] Given that

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369 *See* Liquidity Release, *supra* note 5, at 123 ("Cash and cash equivalents are extremely liquid (in that they either are cash, or could be easily and nearly immediately converted to cash without a loss in value), and significant holdings of these instruments generally decrease a fund's liquidity risk because the fund could use them to meet redemption requests without materially affecting the fund's NAV.").

370 ISDA Margin Survey 2015 (Aug. 2015), *available at* https://www2.isda.org/functional-areas/research/surveys/margin-surveys. The ISDA Margin Survey included 41 ISDA members, approximately 90% of whom were banks or broker-dealers, in the Americas (32%), Europe/Middle East Africa (53%) and Asia (16%). Figures for uncleared margin reflect responses of large firms, *i.e.*, those having more than 3,000 active non-cleared ISDA collateral agreements. Under the ISDA Margin Survey, government agency and government sponsored entity securities, US municipal bonds and supranational bonds were categorized separately from the "government securities" category and therefore are not included in the percentages cited above. As previously noted, examples of items commonly considered to be "cash equivalents" include certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of

the proposed rule's requirements relating to the mark-to-market coverage amount and risk-based coverage amount are conceptually similar to initial margin (which represents an amount collected to cover potential future exposures) and variation margin (which represents an collected to cover current exposures), and that the proposed rule would permit the mark-to-market coverage amount and risk-based coverage amount to be reduced by the value of assets that represent initial or variation margin, we believe that limiting qualifying coverage assets to cash and cash equivalents would be appropriate.

We note that some commenters on the Concept Release opposed a more restrictive requirement for asset segregation, such as the one we are proposing today, stating that a more restrictive approach could limit certain funds' ability to use derivatives.[371] However, we note that these comments were made in the context of the Concept Release, which sought comment on the appropriate amount of segregated assets for a derivatives transaction in the context of the current approach, under which funds segregate the full notional amount for some types of derivatives transactions. The proposed rule, however, would not require funds to segregate a derivative's full notional amount, and instead would require the fund to segregate its mark-to-mark and risk-based coverage amounts. Given the proposed rule's requirement to segregate

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money market funds (*see supra* note 368 and accompanying text). In light of the global nature of the survey and the types of entities surveyed, we request comment below on whether cash and cash equivalents are the assets most commonly used by funds for posting initial and variation margin to their counterparties.

371 *See, e.g.*, AQR Concept Release Comment Letter, at 4 ("If the Merrill Lynch Letter were withdrawn, we believe investors in certain funds would be harmed. Equity funds or high yield funds, for example, would find it difficult to utilize derivatives because these funds do not usually hold large quantities of cash and high grade debt obligations that could be used as collateral."); BlackRock Concept Release Comment Letter, at 5 ("Holding cash and U.S. Government securities to satisfy asset coverage requirements may be in conflict with the stated investment objectives of a fund and effectively would prevent many equity and certain bond funds from being able to use derivatives when derivatives are the most effective ways of implementing portfolio strategies.").

these amounts with respect to their derivatives transactions, we believe it is appropriate to require that the segregated assets be assets that are extremely liquid.

*b. Assets Required to be Delivered Under the Derivatives Transaction*

With respect to any derivatives transaction under which a fund may satisfy its obligations under the transaction by delivering a particular asset, the proposed rule would allow the fund to segregate that particular asset as a qualifying coverage asset.[372] Because, in such derivatives transactions, the fund could satisfy its obligations by delivering the asset itself, we believe that these assets would be an appropriate qualifying coverage asset for such transactions. For example, if the fund has written a call option on a particular security that the fund owns, then the security could be considered a qualifying coverage asset in respect of the written option.[373] In that example, the fund's delivery of such security would satisfy its obligations under the written option and any change in the value or liquidity of such security should not affect the ability of the fund to satisfy its payment obligation under the call option.

Under the proposed rule, the *particular asset* that the fund may deliver to satisfy its obligations under the derivatives transaction would be a qualifying coverage asset. However, a qualifying coverage asset for a derivatives transaction generally would not include a derivative that provides an offsetting exposure. For example, if a fund has written a CDS on a bond, a purchased CDS on the same bond entered into with a different counterparty generally would not be considered a qualifying coverage asset in respect of the written CDS because the fund would

372 Proposed rule 18f-4(c)(8).

373 We note that, in this type of "covered call" transaction where a fund owns the security that is required to be delivered under the written option, the fund could reasonably conclude that the sum of the mark-to-market coverage amount and the risk-based coverage amount for such written option is equal to the value of the security. Thus, the fund could satisfy the asset segregation requirements of the proposed rule by segregating the security itself, without segregating additional qualifying coverage assets.

be exposed to the risk that its counterparty could default or fail to perform its obligation under the purchased CDS, thereby potentially leaving the fund without sufficient assets to satisfy its obligations under the written CDS.[374] Such a result would be inconsistent with the purpose of the asset segregation requirement in the proposed rule, which is designed to enable the fund to meet its obligations arising from the derivatives transaction. In addition, and as discussed in more detail in section III.B.1.d above, we have not included in the proposed rule provisions for particular types of potential hedging and other cover transactions. The same considerations we discuss above in section III.B.1.d similarly weigh against our including exceptions to the asset coverage requirements in the proposed rule for these kinds of transactions.

We recognize that commenters to the Concept Release generally advocated for retaining the flexibility offered by the cover transaction approach.[375] The proposed rule is designed instead to provide some flexibility to funds to determine the appropriate risk-based coverage amount (rather than a derivative's full notional amount), and in this context, we believe that additional flexibility regarding particularized cover transactions (other than those covered by a

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374 We note, however, that if a fund entered into two transactions that were covered by a netting agreement, the proposed rule would permit the mark-to-market coverage amount and risk-based coverage amount to be determined on a net basis, which could result in a reduction in the amount of qualifying coverage assets that the fund would need to segregate if such transactions were offsetting. As discussed in section III.B.1.b.ii, for purposes of the exposure limits under the proposed rule, a fund may net directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms, even if those transactions are entered into with different counterparties and without regard to whether those transactions are subject to a netting agreement. *See* proposed rule 18f-4(c)(3)(i). We believe that it is appropriate to allow such netting for purposes of the proposed rule's exposure limits because in those circumstances, netting can be expected to eliminate a fund's market exposure. By contrast, the proposed rule's asset coverage requirements are designed to address a different primary concern, namely, the ability of a fund to meet its obligations arising from derivatives transactions.

375 *See, e.g.*, ICI Concept Release Comment Letter; SIFMA Concept Release Comment Letter; Oppenheimer Concept Release Comment Letter.

netting agreement as described above) may not address the asset sufficiency concern under the Act.

*c. Limit on the Total Amount of Qualifying Coverage Assets*

Under the proposed rule, the total amount of a fund's qualifying coverage assets could not exceed the fund's net assets.[376] This aspect of the proposed rule is designed to require a fund to have sufficient qualifying coverage assets to meet its obligations under its derivatives transactions and also prohibit a fund from entering into a financial commitment transaction or otherwise issuing senior securities pursuant to section 18 or 61 of the Act and then using the additional assets resulting from such leveraging transactions to support an additional layer of leverage through senior securities transactions. Thus, if a fund borrowed from a bank, for example, the aggregate amount of the fund's assets that the fund might otherwise use as qualifying coverage assets for derivatives transactions would be reduced by the amount of the outstanding bank borrowing. We believe it is appropriate for a fund that enters into derivatives transactions in reliance on the proposed rule to have qualifying coverage assets in excess of the amounts the fund owes to other counterparties so that the fund's qualifying coverage assets would be available to satisfy the fund's obligations under its derivatives transactions if necessary. Therefore, under the proposed rule, the total amount of a fund's qualifying coverage assets could not exceed the fund's net assets.

We request comment on all aspects of the proposed rule's definition of qualifying coverage assets.

- For derivatives transactions, the proposed rule contains the same requirements for qualifying coverage assets in respect of the mark-to-market coverage amount and

[376] Proposed rule 18f-4(c)(8).

the risk-based coverage amount. Should there be a difference in the requirements for qualifying coverage assets in respect of the mark-to-market coverage amount and the risk-based coverage amount? If so, what changes should be made? Should we, for example, permit funds to use a broader range of assets as qualifying coverage assets with respect to a fund's risk-based coverage amount because that amount reflects potential amounts payable by the fund, rather than the mark-to-market payable amounts represented by the fund's mark-to-market coverage amount?

- Under the proposed rule, a fund would generally be required to segregate cash and cash equivalents. Is the range of assets that would be included as cash and cash equivalents sufficiently clear? Are there other types of assets that commenters believe are cash equivalents that we should identify by way of example? Should we instead define "cash equivalents" in the proposed rule? If so, how should we define "cash equivalents"?
- Should we allow funds to segregate other types of assets in addition to cash and cash equivalents? If so, what other types of assets should we allow? For example, should we permit funds to segregate any U.S. government security (i.e. any security issued or guaranteed as to principal and interest by the U.S. government)? Should we allow funds to segregate high grade debt obligations as discussed in Release 10666? If so, how should we define high grade debt obligations for this purpose? Should we permit funds to segregate assets that would be eligible as collateral for margin under the rules that have been proposed or adopted for swap entities? Should we instead allow funds to segregate any

Three-Day Liquid Asset as defined in proposed rule 22e-4? If we were to permit funds to segregate other types of assets in addition to cash and cash equivalents, should we place restrictions on these other types of assets to protect against the risk that the gains and losses on these coverage assets held by the fund may be correlated with the performance of reference assets underlying the fund's derivatives transactions in such a way that they could lose value in stressed market conditions when the fund's liabilities under derivatives transactions may be increasing?

- If we were to allow funds to segregate other assets as qualifying coverage assets (whether for all purposes or only the fund's risk-based coverage amount), what additional measures, if any, should we require funds to undertake in order to protect against potential changes in the value and/or liquidity of such assets? For example, should we impose haircuts on such assets? If so, how should we determine the appropriate haircut? For example, should we incorporate the haircuts described in the SEC's proposed margin requirements for security-based swap dealers and major security-based swap participants?[377] Or, should we incorporate the haircut schedule included in the rules adopted by the banking regulators for covered swap entities?[378] Is there a different haircut schedule that would be more appropriate for the proposed rule?
- If we were to allow funds to segregate other assets as qualifying coverage assets (whether for all purposes or only the fund's risk-based coverage amount), should

[377] *See* Margin and Capital Proposing Release, *supra* note 363.

[378] *See* Prudential Regulator Margin and Capital Adopting Release, *supra* note 160.

we impose additional restrictions if the assets are closely correlated with the exposure created by the derivatives transaction? What types of requirements should we impose for assessing these correlations?

- Under the proposed rule, qualifying coverage assets for derivatives transactions generally would not include a derivative that provides an offsetting exposure. Is this appropriate? Why or why not?
- Some commenters to the Concept Release stated that requiring funds to segregate cash and other high-quality debt obligations could make it difficult for certain funds to use derivatives.[379] Given that the proposed rule would not require funds to segregate assets equal to the full notional value of its derivatives transactions, and would permit a fund to reduce its mark-to-market and risk-based coverage amounts to take account of margin posted by the fund, do such concerns remain?
- Under the proposed rule, the total amount of a fund's qualifying coverage assets could not exceed the fund's net assets. Do commenters agree that this is appropriate? Should we, instead, specify that qualifying coverage assets must not be "otherwise encumbered"? Is there a different approach we should take to prevent a fund from using assets to cover multiple different obligations or potential obligations?
- The proposed rule's asset segregation requirements for derivatives transactions, although designed primarily to enable the fund to meet its obligations arising from its derivatives transactions, also could serve to limit a fund's ability to obtain

[379] *See* Basel Committee on Banking Supervision & Board of the International Organization of Securities Commissions, *Margin Requirements for Non-Centrally Cleared Derivatives* (Mar. 2015), *available at* http://www.bis.org/bcbs/publ/d317.pdf.

leverage through derivatives transactions to the extent that a fund limits its derivatives usage in order to comply with the asset segregation requirements. As noted above, a fund might limit its derivatives transactions in order to avoid having to maintain qualifying coverage assets for the transactions, and the asset segregation requirements may limit a fund's ability to enter into a derivatives transaction if the fund does not have, and cannot acquire, sufficient qualifying coverage assets to engage in additional derivatives transactions. To what extent do commenters believe that the proposed rule's asset segregation requirements would impose a practical limit on the amount of leverage a fund could obtain?

## D. Derivatives Risk Management Program

The use of derivatives can pose a variety of risks to funds and their investors, although the extent of the risk may vary depending on how a fund uses derivatives as part of the fund's investment strategy. As discussed previously, these risks can include the risk that a fund may operate with excessive leverage or without adequate assets and reserves, which are both core concerns of the Act.[380] Other potential risks associated with derivatives use can include market, counterparty, leverage, liquidity, and operational risk. While many of these risks are not limited to derivatives investments, the complexity and character of derivatives investments may heighten such risks.[381]

The proposed rule's portfolio limitations and asset coverage requirements are intended to help limit the extent of the fund's exposure to many of these risks. These requirements are

380 *See, e.g.*, Investment Company Act sections 1(b)(7), 1(b)(8), 18(a), and 18(f); *see also* section II.B.1.

381 *See, e.g.*, 2008 IDC Report, *supra* note 72. *See also Mutual Funds and Derivative Instruments*, Division of Investment Management.

designed both to impose a limit on the amount of leverage a fund may obtain from derivatives and to require the fund to manage its risks by having qualifying coverage assets to meet its obligations while providing funds with flexibility to engage in a wide variety of derivatives transactions and investment strategies. These restrictions on funds' use of derivatives are generally intended to provide limits on the magnitude of funds' derivatives exposures, and in the case of a fund operating under the risk-based limit, to require that the fund's derivatives transactions, in the aggregate, have the effect of reducing the fund's exposure to market risk. These limits and associated risk management requirements would be complemented by the proposed rule's formalized derivatives risk management program requirement, which would require funds that engage in more than a limited amount of derivatives transactions, or that use complex derivatives transactions as defined in the proposed rule, to also have a formalized program that includes policies and procedures reasonably designed to assess and manage the particular risks presented by the fund's use of derivatives.

We have observed that fund investments in derivatives can pose risk management challenges, and poor risk management may cause significant harm to funds and their investors.[382] We understand that, today, the advisers to many funds whose investment strategies could entail derivatives risk routinely conduct risk management to evaluate a fund's derivatives usage.[383] A fund's use of derivatives presents challenges for its investment adviser and board of directors in managing derivatives transactions so that they are employed in a manner consistent with the

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382 *See supra* section II.D.1.d.

383 *See, e.g.*, *Mutual Fund Derivative Holdings: Fueling the Need for Improved Risk Management*, JPMORGAN THOUGHT MAGAZINE (Summer 2008) ("2008 JPMorgan Article"), *available at* http://www.jpmorgan.com/cm/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1158494213964&blobheader=application%2Fpdf&blobnocache=true&blobheadername1=Content; 2008 IDC Report, *supra* note 72.

fund's investment objectives, policies, and restrictions, its risk profile, and relevant regulatory requirements, including those under the federal securities laws.[384] Funds and their advisers may face liability under the antifraud provisions of the federal securities laws if their use of derivatives is inconsistent with these constraints. Accordingly, we understand that advisers to many funds whose investment strategies entail the use of derivatives already assess and manage such risk.

Fund advisers that today engage in active risk management of their derivatives may use a variety of tools. Depending on the fund and its derivatives use, these tools might include a formalized derivatives risk management program led by a dedicated risk manager or risk committee, the use of other checks and balances put in place by a fund's portfolio management team, or other tools.[385] We understand that many fund boards oversee the fund adviser's risk management process as part of their general oversight of the fund.[386] As a result, we believe that the proposed program would likely have the effect of enhancing practices that are in place at many funds today by specifying requirements for funds that rely on the rule to evaluate the risks associated with the funds' use of derivatives and to inform the funds' boards of directors about these risks as part of a regular dialogue with officers of the fund or its adviser.

The proposed measures will help enhance derivatives risk management by requiring that any fund that engages in more than a limited amount of derivatives transactions pursuant to the proposed rule, or that uses complex derivatives transactions, adopt and implement a formalized

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384 *See supra* note 27 and accompanying text.

385 *See*, *e.g.*, 2008 IDC Report, *supra* note 72; *Fund Board Oversight of Risk Management,* Independent Directors Council (Sept. 2011) ("2011 IDC Report"), *available at* http://www.ici.org/pdf/pub_11_oversight_risk.pdf.

386 *See*, *e.g.*, 2011 IDC Report, *supra* note 385, at 9.

derivatives risk management program (a "program").[387] The program's requirements would be in addition to the requirements related to derivatives risk management that would apply to every fund that enters into derivatives transactions, including, for example, the requirement to manage derivatives risk through determining the risk-based coverage amounts on a daily basis, and the requirement to monitor compliance with the proposed portfolio limit under which the fund's derivatives exposure may not exceed 50% of net assets and the fund may not enter into complex derivatives transactions. The formalized risk management program condition would require a fund to have policies and procedures reasonably designed to:

(i) assess the risks associated with the fund's derivatives transactions, including an evaluation of potential leverage, market, counterparty, liquidity, and operational risks, as applicable, and any other risks considered relevant;

(ii) manage the risks of the fund's derivatives transactions, including by monitoring the fund's use of derivatives transactions and informing portfolio management of the fund or the fund's board of directors, as appropriate, regarding material risks arising from the fund's derivatives transactions;

(iii) reasonably segregate the functions associated with the program from the portfolio management of the fund; and

(iv) periodically (but at least annually) review and update the program.[388]

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387 Proposed rule 18f-4(a)(3). As discussed in greater detail below, the derivatives risk management program requirement that we are proposing today would only apply to "derivatives transactions," and not to other senior securities transactions, such as financial commitment transactions as defined under the rule.

388 *See* proposed rule 18f-4(a)(3).

The program, which would be administered by a designated derivatives risk manager, would require funds, at a minimum, to adopt policies and procedures reasonably designed to implement certain specified elements, and would include administration and oversight requirements. The program is expected to be tailored by each fund and its adviser to the particular types of derivatives used by the fund and the manner in which those derivatives relate to the fund's investment portfolio and strategy. Funds that make only limited use of derivatives would not be subject to the proposed condition requiring the adoption of a formalized derivatives risk management program under the proposed rule.

Proposed rule 18f-4 would include board oversight provisions related to the derivatives risk management program requirement. Specifically, a fund's board would be required to approve the fund's derivatives risk management program, any material changes to the program, and the fund's designation of the fund's derivatives risk manager (who cannot be a portfolio manager of the fund).[389] The board also would be required to review written reports prepared by the designated derivatives risk manager, at least quarterly, that review the adequacy of the fund's derivatives risk management program and the effectiveness of its implementation.[390] A fund might, as it determines appropriate, expand its derivatives risk management procedures beyond the required program elements and should consider doing so whenever it would be necessary to ensure effective derivatives risk management.

The proposed derivatives risk management program would serve as an important complement to the other conditions of proposed rule 18f-4. We expect that the rule's portfolio limitations and asset coverage requirements would provide "guard rails" designed to impose a

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389 Proposed rule 18f-4(a)(3)(ii).

390 Proposed rule 18f-4(a)(3)(ii)(B).

limit on leverage and to require funds to have qualifying coverage assets to meet their obligations, which should help to limit funds' exposure to some of the risks associated with the use of derivatives. Nonetheless, for funds that engage in more than a limited amount of derivatives use, or that use complex derivatives, we believe that the outside limits set by the proposed portfolio limitations and the protections provided by the asset coverage requirements should be coupled with a formalized risk management program tailored to the ways which funds use derivatives and the specific risks to which funds are exposed.

While we recognize that many funds already engage in significant risk management of their derivatives transactions, we have observed that the quality and extent of such practices vary among funds in that some funds have carefully structured risk management programs with clearly allocated functions and reporting responsibilities while others are left largely to the discretion of the portfolio manager. In light of the dramatic growth in the volume and complexity of the derivatives markets over the past two decades, and the increased use of derivatives by certain funds, we believe that in connection with providing exemptive relief from section 18, it is appropriate to require certain funds to have a formalized risk management program focused on the particular risks of these transactions. We believe that requiring a risk management program that meets the requirements in the proposed rule should serve to establish a standardized level of risk management for funds that engage in more than a limited amount of derivatives use or that use complex derivatives, and thus should provide valuable additional protections for the shareholders of such funds.

### *1. Funds Subject to the Proposed Risk Management Program Condition*

We are proposing that funds that exceed a 50% threshold of notional derivatives exposure would be subject to the specific risk management program condition discussed here. Under section 18, open- and closed-end funds are permitted to engage in certain senior securities transactions, as discussed above, subject to a 300% asset coverage requirement or a 200% coverage requirement for closed-end fund issuance of preferred equity. A mutual fund therefore can borrow from a bank (and a closed-end fund can issue other senior securities) under section 18 provided that the amount of such borrowings (or other senior securities) does not exceed one-third of the fund's total assets, or 50% of the fund's net assets.[391] This threshold represents a determination by Congress of an appropriate amount of senior security transactions that funds may achieve through bank borrowings (and certain other transactions in the case of closed-end funds).[392]

As discussed previously, for a number of reasons we have determined to propose to permit a fund to engage in derivatives transactions provided it complies with all of the conditions in proposed rule 18f-4. Under the proposal, if a fund exceeds a threshold of 50% notional amount of derivatives transactions, that fund must adopt and implement a formalized risk management program.[393] We believe that a threshold analogous to the statutorily defined

391 Under section 18(h), "asset coverage" of a class of senior security representing an indebtedness of an issuer means the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer." Take, for example, an open-end fund with $100 in assets and with no liabilities or senior securities outstanding. The fund could, while maintaining the required coverage of 300% of the value of its assets subject to section 18 of the Act, borrow an additional $50 from a bank; the $50 in borrowings would represent one-third of the fund's $150 in total assets, measured after the borrowing (or 50% of the fund's $100 net assets).

392 As discussed in section III.B.1.c above, we also have considered whether the 50% limitation that Congress established for obligations and leverage through the use of bank borrowings should also be applied to limit the use of derivatives transactions and have noted that derivatives differ in certain respects from borrowings permitted under section 18. *See supra* note 207 and accompanying text.

393 We note that under the proposed rule, the threshold for implementing a derivatives risk management program would be triggered by the notional exposure of the fund's derivatives transactions only, and would not include the exposure to a fund's financial commitment or other senior securities transactions. This is in contrast to other aspects of the proposed rule's calculations of exposure, which would include in the calculation all senior securities transactions,

threshold for senior securities under section 18 represents a level of derivatives use, which if exceeded, should be managed through such a derivatives risk management program.[394] Because we expect that a risk management program should help mitigate the risks associated with a fund incurring obligations from the use of derivatives above the statutory defined level that would be permitted for borrowings, we believe that this requirement is consistent with the exemption we are providing today for these transactions.

While we are proposing that a formalized risk management program would be a requirement only for those funds that exceed the 50% threshold or that use complex derivatives transactions, all funds that enter into derivatives transactions in reliance on the proposed rule would also be required to manage risks relating to their derivatives transactions through compliance with various other requirements of the proposed rule and other rules under the Act. For example, under our proposal, a fund that engages in even a single derivatives transaction would be required to manage the risks of those derivatives transactions by segregating qualifying coverage assets determined at least once each business day.[395] This would require the fund each business day to determine the risk-based coverage amount for each of its derivatives transactions which we believe would enable the funds to better manage their risks relating to the use of derivatives. This risk-based coverage amount would be determined in accordance with policies and procedures approved by the fund's board and would represent a reasonable estimate of the amount payable by the fund if it were to exit the derivatives transaction under stressed

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not just derivatives. Rule 18f-4(a)(4). We are taking this approach because, as discussed throughout this Release, the risks of derivatives transactions often differ in magnitude and kind from the risks of other senior securities transactions.

394 *See supra* section II.D.1.d. *See also supra* note 207 and accompanying text.

395 This risk management requirement is discussed in detail in section III.C of this Release.

conditions. Thus, the fund would be required to monitor and manage the potential risk of loss associated with each of its derivatives transactions on a daily basis as part of the fund's determination of its risk-based coverage amounts, and all funds would therefore be required under the proposed rule to make an assessment of potential losses associated with their derivatives transactions under stressed conditions. This risk management requirement applies to every fund that uses derivatives, regardless of whether it is also subject to the formalized derivatives risk management program condition.

In addition, a fund that is not required to establish a formalized risk management program must comply, and monitor its compliance, with the portfolio limitation under which the fund may not permit its derivatives exposure to exceed 50% of the fund's net assets immediately after entering into any derivatives transactions and may not enter into any complex derivatives transactions.[396] A fund that uses any derivatives would be required to monitor the types and notional amounts of the fund's derivatives transactions and the fund's aggregate exposure to prevent the fund's derivatives exposure from exceeding 50% of net assets and to prevent the fund from entering into complex derivatives transactions.[397] Thus, funds that are not subject to the proposed formalized risk management program condition would nevertheless need to manage

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[396] Proposed rule 18f-4(4).

[397] In addition, rule 38a-1 would also require funds to have policies and procedures reasonably designed to prevent the fund from exceeding any other applicable portfolio limitation under the proposed rule. *See* Compliance Programs of Investment Companies and Investment Advisers, Release Nos. IA-2204 and IC-26299 (December 17, 2003). If a fund were to breach the portfolio limitation established by the board, this would likely be a material compliance matter that would be required to be disclosed in writing to the fund's board in the CCO's annual report to the board. We expect that this may serve to further enhance funds' risk management practices. In addition, a fund's exceeding its portfolio limit also could be a serious compliance issue that should be brought to the board's attention promptly. *See infra* note 449.

risks relating to their use of derivatives through their compliance with the risk assessment, monitoring, and other regulatory requirements discussed above.

The risks and potential impact of derivatives transactions on a fund's portfolio generally increase as the fund's level of derivatives usage increases.[398] When derivatives are used to a significant extent, we expect the risks relating to their use, and the challenge of managing risks relating to expected or intended interactions among derivatives and other investments and managing relationships with counterparties, may increase. Complex derivatives also may involve more significant risks and potential impacts. Conversely, for funds that make only limited use of derivatives and do not use complex derivatives, we expect that the risks and potential impact of these funds' derivatives transactions may not be as significant in comparison to the risks of the funds' overall investment portfolios and may be appropriately addressed by the rule's other requirements, including the requirement to determine risk-based coverage amounts.[399] Therefore, we believe that a formalized risk management program that includes the specific program elements included in the proposed rule is most appropriate for funds that meet a threshold level of derivatives usage (or that use complex derivatives transactions).

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398 We acknowledge that derivatives can be used for both hedging and speculative purposes, but even if primarily used for hedging purposes, we believe that significant use of derivatives instruments poses additional risks that may need to be assessed, monitored, and managed. *See, e.g.*, David Weinberger, et al., *Using Derivatives: what senior managers must know*, HAR. BUS. REV. (Jan.-Feb. 1995), *available at* https://hbr.org/1995/01/using-derivatives-what-senior-managers-must-know; Sergey Chernenko & Michael Faulkender, *The Two Sides of Derivatives Usage: hedging and Speculating with interest rate swaps*, J. OF FIN. AND QUANTITATIVE ANALYSIS, (Dec. 2011), *available at* http://journals.cambridge.org/download.php?file=%2FJFQ%2FJFQ46_06%2FS0022109011000391a.pdf&code=0d15622321dedaa274f024857fd4885c.

399 Funds that are not required to adopt and implement a derivatives risk management program should generally still consider the risks of derivatives, because even small amounts of derivatives may pose significant risks if engaged in by an entity that is an inexperienced user of such instruments or when adverse market events occur. *See, e.g.*, Rene M. Stulz, *Should we fear derivatives?*, J. OF ECON. PERSPECTIVES (Summer 2004), *available at* http://fisher.osu.edu/supplements/10/10402/Should-We-Fear-Derivatives.pdf.

Accordingly, proposed rule 18f-4 would not require that a fund adopt a formalized derivatives risk management program if the fund's board determines that the fund will comply, and monitor its compliance, with a portfolio limitation under which the fund limits its aggregate exposure to derivatives transactions to no more than 50% of its NAV and does not use complex derivatives transactions as defined in the rule.[400] We believe that a fund that limits its exposure to derivatives in such a way (in conjunction with the other requirements of the rule) should be able to limit the derivatives' associated risk so that their usage is consistent with the concerns of the Act.[401] Requiring a formalized program for managing derivatives when a fund engages in non-complex derivatives transactions below the statutorily defined limit established by Congress with respect to senior securities transactions could potentially require funds (and therefore their shareholders) to incur costs that might be disproportionate to the resulting benefits, and thus we are not proposing to require that all funds that use derivatives to any extent implement one. Nonetheless, as discussed in greater detail below, we request comment on whether the risks of derivatives use are significant enough (or significantly different from securities investments) that we should require funds that engage in any derivative use at all to comply with the proposed formalized risk management program condition.

To identify the number of funds that would need to adopt a program under this condition we evaluated the DERA White Paper data and evaluated which funds would be likely to be subject to this proposed condition. Based on this analysis, approximately 10% of the sampled

400 Proposed rule 18f-4(a)(4).

401 Although we believe that any fund that engages in derivatives would likely evaluate the risks of such transactions as part of the adviser's management of the fund's portfolio, we are not proposing that funds that keep their use of derivatives below the 50% threshold be subject to the proposed program requirements under rule 18f-4 unless the fund uses complex derivatives transactions, as discussed below.

open-end funds (representing about 10% of such funds' assets under management ("AUM")) and approximately 9% of the sampled closed-end funds (representing about 13% of their AUM) would be required to adopt a program.[402] We further note that this condition also would effectively sort funds that would need to adopt a program based on fund strategy. For example, approximately 52% of sampled alternative strategy funds (representing around 70% of AUM) would need to implement a program. On the other hand, the analysis shows that only about 6% of sampled funds (representing about 8% of their AUM) that employ more traditional strategies use derivatives in excess of a 50% level.[403]

This 50% exposure condition would include exposures from derivatives transactions entered into by a fund in reliance on the proposed rule, but would not include exposure from financial commitment transactions or other senior securities transactions entered into by the fund pursuant to section 18 or 61 of the Act. We are proposing to focus this exposure threshold on exposures from derivatives transactions for several reasons. Derivatives transactions generally can pose different kinds of risks than many other kinds of senior securities transactions, in that the amount of a fund's market exposure and payment obligations under many derivatives transactions often will be more uncertain than for other types of senior securities transactions. In contrast, the fund's payment obligation may be largely known and fixed at the time the fund enters into many financial commitment transactions, such as reverse repurchase agreements or firm commitment agreements. In addition, the proposed rule would require a fund that engages in financial commitment transactions in reliance on the rule to maintain qualifying coverage

402 We note that no BDC's identified in the DERA White Paper used derivatives at any level, and thus we do not expect that any BDCs would be required to implement a program under the proposed condition.

403 We note the exception of certain leveraged index ETFs that serve as trading tools and that commonly have notional exposure of 200 or 300% of assets.

assets equal in value to the fund's conditional and unconditional obligations under its financial commitment transactions.[404] Requiring a fund to maintain qualifying coverage assets sufficient to cover its full obligations under a financial commitment transaction may effectively address many of the risks that otherwise would be managed through a risk management program. The mark-to-market segregation approach would not be permitted under the proposed rule for financial commitment transactions. Finally, commenters on the Concept Release and on the FSOC Request for Comment have suggested that funds obtain leverage primarily from the use of derivatives and not financial commitment transactions, further indicating that derivatives use poses a different set of challenges than other types of senior securities transactions.[405]

We also are proposing to require a fund that engages in <u>any</u> complex derivatives transaction as defined under the proposed rule to implement a program. We believe that complex derivatives transactions pose special risk management challenges in light of their complicated structure and the difficulties they can pose in evaluating their impact on a fund's portfolio. As discussed in more detail above in section III.B.1, a complex derivatives transaction may expose a fund to greater risk of loss and can have market risks that are difficult to estimate due to the effect of multiple contingencies, path dependency or other non-linear factors associated with complex derivatives. We believe that a fund that engages in complex derivatives

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404 Proposed rule 18f-4(b).

405 *See, e.g.*, Comment Letter of T. Rowe Price Associates, Inc. on the FSOC Request for Comment (Mar. 25, 2015) (FSOC 2014-0001) ("T. Rowe Price FSOC Comment Letter"), *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2014-0001-0038, at 3; Comment Letter of State Street Corporation on the FSOC Request for Comment (Mar. 25, 2015) (FSOC 2014-0001) ("State Street FSOC Comment Letter"), *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2014-0001-0042 at 11; Oppenheimer Concept Release Comment Letter, at 1-2; Comment Letter of Independent Directors Council on Concept Release (Nov. 7, 2011) (File No. S7-33-11) ("IDC Concept Release Comment Letter"), *available at* http://www.sec.gov/comments/s7-33-11/s73311-24.pdf, at 2-4.

transactions under the proposed rule should be required to implement a derivatives risk management program to manage these risks as they are more complex and difficult to assess and manage than typical derivatives. Because of their potentially highly asymmetric and unpredictable outcomes, complex derivatives transactions may pose risks that are not as correlated to the size of a fund's exposure, and thus we believe that if a fund engages in any of these transactions, those risks should be assessed and managed through a formalized derivatives risk management program overseen by a risk manager and the funds' board. Accordingly, we are proposing that a fund that engages in any amount of complex derivatives transactions adopt a derivatives risk management program.

We request comment on our proposed approach for identifying funds that must comply with the program requirement for funds that engage in a limited amount of derivatives transactions.

- Should the formalized derivatives risk management program apply not just to derivatives transactions, but to all senior securities transactions? Should it apply to just derivatives and financial commitment transactions? Do commenters agree that derivatives transactions generally can pose different kinds of risks than many other kinds of senior securities transactions, and that requiring a fund to maintain qualifying coverage assets sufficient to cover its full obligations under a financial commitment transaction may effectively address many of the risks that otherwise would be managed through a risk management program?
- As we are proposing, should we exclude from the formalized program requirement funds that engage in a limited amount of derivatives transactions?

Are the risks associated with derivatives use significant enough (or significantly different from securities investments) that a fund should be required to adopt a program if it engages in any derivatives transactions? Should we instead require any fund that engages in derivatives transactions to any extent be subject to the program requirement?

- Should we require a formalized risk management program for funds that engage in even lower levels of derivatives use than under the proposed condition if they rely on the proposed rule? Should this condition not be based on the statutory threshold but instead on a different threshold? For example, are the risks of derivatives use significant enough that we should require a fund to have a program at a lower threshold, for example at 0%, 10%, 25%, or 33% of net assets? On the other hand, are the risks of derivatives use manageable enough that we should increase the threshold to avoid requiring funds to incur costs associated with a derivatives risk management program unless they make more extensive use of derivatives? For example, should the threshold for exposure instead be 66% or 75% of net assets? If we were to use a higher threshold, would that permit funds to obtain levels of derivative exposure that could pose more substantial risks to the fund before the fund would be required to establish a formalized derivatives risk management program?
- The 50% exposure condition only includes exposure from a fund's derivatives transactions but not its financial commitment transactions or other senior securities transactions. Do commenters agree that it is appropriate to exclude exposures from other senior securities transactions in determining whether to

require a formalized derivatives risk management program? Should we treat particular types of derivatives transactions or financial commitment transactions differently for purposes of the 50% exposure condition? Should we, for example, require a fund to include the exposure associated with financial commitment transactions other than reverse repurchase agreements, which may be more similar to bank borrowings and thus may not involve some of the risks and uncertainties associated with other senior securities transactions?

- Should we vary the condition based on fund characteristics or the types of derivatives transactions? For example, should we provide tiered thresholds based on a fund's assets under management, requiring funds of a larger size to be subject to a lower threshold? Would such a tiered threshold provide material protections for investors at a reasonable cost? Would it create disparate competitive effects on different sized funds? Is the size of the fund an appropriate metric to scale requirements designed to manage the risk of derivatives use? Should we provide for higher thresholds if a fund engages only in certain kinds of derivatives transactions? If so, then what types of derivatives transactions would be expected to present less risk?
- Should we use some test other than an exposure threshold for excluding funds that make a limited use of derivatives from the program requirement? For example, should we use a risk-based test? If so, should we specify what kind of test (e.g., VaR, expected shortfall, or some other metric) and what threshold should we use? Should we require a specified threshold at all, or should we instead allow a board to determine a risk-based threshold?

- As we are proposing, should we require that all funds that engage in any complex derivatives transactions implement a program? Why or why not? Should we instead permit funds to obtain a limited amount of exposure through complex derivatives transactions (*e.g.*, 1% or 5% of net assets) before being required to implement a derivatives risk management?

As discussed above, a risk management program should be tailored to the scale of the fund's usage of derivatives, as well as the particular risks of the derivatives used by the fund. Therefore, funds that engage in significant amounts of derivatives transactions, or that use complex derivatives transactions, are likely to have more detailed and complex programs, while funds that make more minimal use or limit their use to more standard derivatives may have more streamlined programs tailored to their particular usage. As proposed, all of the elements of the proposed risk management program, however, would apply equally to all funds that exceed the 50% threshold.[406] We expect that providing a single set of requirements for all funds that engage in more than a limited amount of derivatives transactions or that use complex derivatives transactions should provide a consistent baseline for these funds' risk management programs. Nonetheless, we acknowledge that this approach may cause certain funds to bear higher costs in complying with all of the requirements of the program than if we were to further scale or otherwise tailor the program depending on the amount or type of fund derivatives use.

- We request comment on whether we should further tailor or scale the program depending on the fund's use of derivatives. For example, should we have

[406] Although, as discussed previously, we note that all funds, even those not subject to the formalized risk management condition, would be required to manage the risks associated with their derivative transactions through compliance with our regulatory requirements, and we request comment on whether we should apply the program's requirements to all funds that engage in derivatives transactions at any level.

multiple tiered thresholds, with differing program requirements tailored to each level of use? If so, which thresholds should we use and which program elements should be included at each level? Should we otherwise tier or scale the program such as, for example, by requiring certain additional program elements for funds that engage in specific types of derivatives? If so, how should we tailor such a requirement? For example, should we require funds that only engage in certain simple types of derivatives not to have a derivatives risk manager?

- If we were to eliminate the proposed 50% threshold and require funds that engage in any amount of derivatives transactions to comply with the risk management program condition, should we provide a more streamlined or simpler program that does not include all of the elements of the full program we are proposing today? If so, which elements should we not include in such a more limited program? If we were to provide for a more limited program for such funds, should we continue to require all of the proposed program elements for funds that use derivatives above the proposed 50% threshold?

*2. Required Elements of the Program*

Under the proposal, a derivatives risk management program must include, at a minimum, four specified elements, discussed in detail below.

a. Assessment of Risks

The first proposed element of the program would be to require funds subject to the condition to have policies and procedures reasonably designed to assess the risks associated with the fund's derivatives transactions, including an evaluation of potential leverage, market, counterparty, liquidity, and operational risks, as applicable, and any other risks considered relevant.[407] This element would require funds to engage in a process of identifying and evaluating the potential risks posed by their derivatives transactions. This element provides flexibility for funds to customize their derivatives risk management programs so that the scope, and related costs and burdens, of such programs are appropriate to manage the anticipated derivatives risks faced by a particular fund. Thus, in complying with this element, a fund generally should identify the types of derivatives it currently uses, as well as any potential derivatives transactions it reasonably expects to use in the future and then evaluate the risks of engaging in those transactions as contemplated.

This program element would require policies and procedures for evaluating certain identified potential risks that are common to most derivatives transactions, as appropriate.[408] The first is the potential leverage risks associated with a fund's derivatives transactions. Leverage risk, which includes the risk associated with potential magnified effects on a fund resulting from changes in the market value of assets underlying its derivatives transactions where the value of the underlying assets exceeds the amount paid by the fund under the derivatives transactions, would need to be assessed under the fund's risk management program.[409] Leverage can be

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407 While these risks are not unique to a fund's use of derivatives and may be associated with the fund's investments in other instruments as well, the proposed condition would require that the program assess and manage the risks associated with the derivatives transactions engaged in by the fund, but would not generally apply to other fund transactions. Proposed rule 18f-4(a)(3).

408 Proposed rule 18f-4(a)(3)(i)(A). *See also Comprehensive Risk Management of OTC Derivatives; A Tricky Endeavour*, Numerix (July 16, 2013) ("Comprehensive Risk Management of OTC Derivatives"), *available at* http://www.numerix.com/comprehensive-risk-management-otc-derivatives-tricky-endeavor; *Statement on best practices for managing risk in derivatives transactions,* RMA ("Statement on best practices for managing risk in derivatives transactions"), *available at* http://www.rmahq.org/securities-lending/best-practices; 2008 IDC Report, *supra* note 72; *Derivatives Danger: internal auditors can play a role in reigning in the complex risks associated with financial instruments*, Lawrence Metzger, FSA Times ("FSA Times Derivatives Dangers"), *available at* http://www.theiia.org/fsa/2011-features/derivatives-danger.

409 *See*, *e.g*., 2008 IDC Report, *supra* note 72, at 12.

calculated in different ways, and the appropriateness of a leverage metric used by the fund, if any, to assess leverage risk may depend on various factors, such as a fund's strategy, the fund's particular investments and investment exposures, and the historical and expected correlations among the fund's investments.[410]

While the proposed exposure limitations included in each of the portfolio limitations are designed to provide a limit on the amount of leverage a fund may obtain by placing an outside limit on the overall amount of market exposures that a fund can achieve through derivatives transactions, the exposure limitations are not designed to be used as a precise measure of the leverage used by funds. A fund, in assessing the leverage risk associated with its derivatives, could consider using metrics for measuring the extent of its leverage, and which metrics to use, in light of these and other relevant factors.[411] Assessing leverage risks might include, for example, a review of the fund's derivatives transactions to evaluate the leverage resulting from the fund's derivatives transactions, whether such leverage is consistent with any guidelines established by the fund, and whether the leverage used by the fund is consistent with its disclosure to investors.[412]

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410 *See*, *e.g.*, An Overview of Leverage, *supra* note 167 (distinguishing between financial, construction and instrument leverage and measurement of leverage using gross market exposure vs. net market exposure). *See also* Off-Balance-Sheet Leverage IMF Working Paper, *supra* note 79 (discussing means of measure leverage in various derivatives and other off-balance-sheet transactions). *See also* Ang, Gorovyy & Inwegen, *supra* note 72 (discussing differences among gross leverage, net leverage and long-only leverage calculations as applied to long-only, dedicated long-short, general leveraged and dedicated short funds).

411 We note that commenters have suggested a variety of methods of calculating leverage for various purposes. For example, one commenter on our recent proposal to modernize reporting for investment companies suggested a possible methodology for calculating leverage that might be reported to the Commission. *See,* Comment Letter of Blackrock on Data Gathering Release (Aug.11, 2015) (File No. S7-09-15), *available at* http://www.sec.gov/comments/s7-09-15/s70915-39.pdf, at 20. We request comment below in section II.G on whether we should require the reporting of leverage (including potentially using this approach) to us on N-PORT.

412 *See supra* note 167 and section III.B.1.d regarding ways that commenters have noted that they

The second risk that the fund would be required to have policies and procedures reasonably designed to evaluate is the market risk associated with its derivatives transactions. Market risk includes the risk related to the potential that markets may move in an adverse direction in relation to the fund's derivatives positions and so adversely impact fund returns and the fund's obligations and exposure.[413] Evaluating market risk could include examining any models or metrics used to measure and monitor market movements, reviewing historical market movements to help develop an understanding of the potential impact of future market movements, and assessing the method and sources for receiving information about current events that may have market impacts. Scenario or stress testing can also serve as an important tool in assessing market risk. To effectively monitor market risk, the adequacy of any assumptions and parameters underlying a fund's techniques for estimating potential market risk should generally be reviewed periodically against actual experience and updated market information, especially during periods of heightened market volatility.[414]

The third risk the fund would be required to have policies and procedures reasonably designed to evaluate is counterparty risk. This might include, for example, an evaluation of the risk that the counterparty on a derivatives transaction may not be willing or able to perform its

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engage in an evaluation of leverage used by funds.

413 Market risk should be considered together with leverage risk because leveraged exposures can magnify such impacts. *See, e.g.*, Derivatives and Risk Management Made Simple, NAPF (Dec. 2013), *available at* https://www.jpmorgan.com/cm/BlobServer/is_napfms2013.pdf?blobkey=id&blobwhere=1320663533358&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs.

414 *See, e.g.*, *Top ten best practices for managing model risk,* FinCAD, *available at* http://www.fincad.com/resources/resource-library/whitepaper/top-10-best-practices-managing-model-risk. In addition, as discussed in more detail below, one of the elements of the proposed program would require the fund to adopt and implement written policies and procedures to periodically review and update the program and any tools that are used as part of the program. *See infra* section III.D.2.d.

obligations under the derivatives contract, and the related risks of having a concentration of transactions with any one such counterparty. Assessing counterparty risk could involve reviewing the creditworthiness or financial position of significant derivatives counterparties, understanding the level of counterparty concentration in the fund, and evaluating contractual protections, such as collateral or margin requirements, netting agreements and termination rights.[415]

The fourth risk the fund would be required to have policies and procedures reasonably designed to evaluate is liquidity risk. Under this program element, a fund should assess the potential liquidity of the fund's derivatives positions, an evaluation which might include both normal and stressed scenarios.[416] Assessing liquidity risk could involve understanding the secondary market liquidity of the fund's derivatives holdings; whether the fund has the right to terminate a particular derivative or the ability to enter into offsetting transactions; the relationship between a particular derivative and other portfolio positions of the fund, including whether the derivative is intended to hedge risks relating to other positions; and the potential effect of market stress events on the liquidity of the fund's derivatives transactions.

In addition to the liquidity of the derivatives positions themselves, assessing liquidity risk generally should include an evaluation of the potential liquidity demands that may be imposed on

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415 *See, e.g.,* Nils Beier, et al., *Getting to Grips with Counterparty Risk*, MCKINSEY WORKING PAPERS ON RISK, NUMBER 20 (June 2010).

416 We have recently proposed a comprehensive set of reforms designed to enhance funds' liquidity management processes, which includes evaluating the liquidity of fund derivative holdings, as well as a definition of liquidity risk. *See* Liquidity Release, *supra* note 5. If we were to adopt the liquidity risk management program, we expect that such program would serve as a complement to the proposed derivatives risk management program with respect to assessing the liquidity of fund derivatives and that these programs might coordinate and overlap regarding assessment of liquidity risk for derivatives. We note that overlapping activities associated with the program would not need to be duplicated for each program, but that a fund might assess and monitor liquidity risk in a holistic way, consistent with the individual requirements of each program.

the fund in connection with its use of derivatives. As discussed in more detail above in section III.C, each fund would be required under the proposed rule to manage the risks associated with its derivatives transactions by maintaining qualifying coverage assets to cover the funds' mark-to-market coverage amount and risk-based coverage amount with respect to the fund's derivatives transactions. In addition, counterparties or applicable regulations generally require funds to post variation margin when derivatives positions move against the fund, and the coverage amounts required under the proposed rule can be expected to increase during periods of increased market stress or volatility. A risk management program, as part of the assessment of liquidity risk, generally should consider how the fund would address potential liquidity demands during reasonably foreseeable stressed market periods.[417]

Finally, the fund would be required to have policies and procedures reasonably designed to assess the operational risks associated with the fund's derivatives transactions. Operational risk encompasses a wide variety of possible events, including risks related to potential documentation issues, settlement issues, systems failures, inadequate controls, and human error.[418] Policies and procedures for evaluating such risks could include, for example, assessments of the robustness of relevant systems and procedures and reviews of training processes.

These five identified potential categories of risk discussed above are common to many derivatives transactions. However, this proposed element would not limit this assessment to an

417 *See, e.g.*, Peter Neu & Pascal Vogt, *Liquidity Risk Management*, The Boston Consulting Group (Oct. 2010), *available at* http://www.bostonconsulting.com.au/documents/file93481.pdf; Board of the International Organization of Securities Commissions, *Principles of Liquidity Risk Management for Collective Investment Schemes,* OICU-IOSCO (Mar. 2013), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf.

418 *See, e.g*, 2008 IDC Report, *supra* note 72; Statement on best practices for managing risk in derivatives transactions, *supra* note 408.

examination of only those identified risks. This element should also generally include evaluation of other applicable risks associated with derivatives transactions. For example, some derivatives transactions could pose certain idiosyncratic risks, such as the legal risk associated with the potential that a bespoke OTC contract[419] or netting agreement might not be held to be legally valid or binding or compliant with other legal requirements, or that have provisions that may be one-sided or difficult to enforce in the event of a counterparty's default.[420] Such risks should also be included in the fund's risk assessment, if applicable.

We request comment on all aspects of this proposed element of the program.

- Should we require policies and procedures to include an assessment of particular risks based on an evaluation of certain identified risk categories as proposed? If not, why?
- Are the categories of risks that we have identified in the proposed rule appropriate? Should we remove any of the identified risk categories? Should we provide further guidance regarding the assessment of any of these risks?
- Should we add any other categories of required risks that would be required for each fund to have policies and procedures reasonably designed to evaluate as part of its program? If so what additional categories and why?

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419 Because derivatives contracts that are traded over the counter are not standardized, they bear a certain amount of legal risk in that poor draftsmanship, changes in laws, or other reasons may cause the contract to not be legally enforceable against the counterparty. *See*, *e.g.*, Comprehensive Risk Management of OTC Derivatives, *supra* note 408.

420 For example, many derivatives contracts and prime brokerage agreements that hedge funds and other counterparties had entered into with Lehman Brothers included cross-netting that allowed for payments owed to and from different Lehman affiliates to be offset against each other, and cross-liens that granted security interests to all Lehman affiliates (rather than only the specific Lehman entity entering into a particular transaction). In 2011, the U.S. Bankruptcy Court for the Southern District of New York held that cross-affiliate netting provisions in an ISDA swap agreement were unenforceable against a debtor in bankruptcy. *In re* Lehman Brothers Inc., Bankr. Case No. 08-01420 (JPM) (SIPA), 458 B.R. 134, 1135-137 (Bankr. S.D.N.Y. Oct. 4, 2011).

- Should we require policies and procedures for any additional evaluation of derivatives positions that are used by a fund to provide a hedge for, or otherwise reduce risks with respect to, other investments by the fund, to evaluate the effectiveness of the hedging or risk reduction?

b. Management of Risks

The second proposed element of the program would be a requirement that the fund have policies and procedures reasonably designed to manage the risks of its derivatives transactions, including by monitoring whether those risks continue to be consistent with any investment guidelines established by the fund or the fund's investment adviser, the fund's portfolio limitation established under the proposed rule, and relevant disclosure to investors, and informing portfolio management of the fund or the fund's board of directors, as appropriate, regarding material risks arising from the fund's derivatives transactions.[421] Implementing this element might include building or enhancing portfolio tracking systems, exception reporting, or other mechanisms designed to monitor the risks associated with the fund's derivatives transactions and provide current information regarding those risks to relevant personnel.[422] We believe that various kinds of stress testing may also be useful tools to monitor and manage risks.

Under this element, a fund would be required to have policies and procedures reasonably designed to manage the risks of derivatives transactions, but this element would not require a

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421 Proposed rule 18f-4(a)(3)(i)(B).

422 Such systems may provide notifications of red flags, such as frequent or unusual overrides of policies. Funds may wish to consider whether such monitoring mechanisms are sophisticated enough to identify outlier activity caused by unapproved employee activity (such as a rogue trader). *See*, *e.g.*, Geoff Kates, *No Surprises-Combatting Rogue Trading*, LEPUS, *available at* http://www.isda.org/c_and_a/ppt/Rogue_Traders_presentation.ppt; Banking Tech, *Stopping the rogues: reactions to the UBS rogue trader* (Oct. 6, 2011), *available at* http://www.bankingtech.com/48103/Stopping-the-rogues-Reactions-to-the-UBS-rogue-trader/.

fund to impose particular risk limits.[423] Instead, it would require a fund to have policies and procedures reasonably designed to manage the risks of derivatives transactions so that they are consistent with any investment guidelines established by the fund or the fund's investment adviser and the fund's portfolio limitations, disclosure, and investment strategy.[424]

Funds may use a variety of approaches in developing policies and procedures to manage the risks associated with the fund's derivatives transactions.[425] As a preliminary step, a fund would likely review its relevant disclosure and investment guidelines to establish the appropriate risks that the fund could undertake through derivatives transactions (for example through specified allowable types of derivatives transactions or overall limits). This review could involve establishing an appropriate limit for allowable fund risk, and its relationship to the risks associated with the derivatives transactions in which the fund engages.[426] Funds today use a variety of models or methodologies to measure the risks associated with these transactions (for example, VaR, stress testing, or horizon analysis) to help manage those risks.

In managing and monitoring the relevant risks, a fund might consider establishing written guidelines describing the scope and objectives of the fund's use of derivatives. A fund could

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423 *See, e.g.*, Mutual Fund Directors Forum, *Risk Principles for Fund Directors: Practical Guidance for Fund Directors on Effective Risk Management Oversight* (Apr. 2010) ("MFDF Guidance"), *available at* http://www.mfdf.org/images/Newsroom/Risk_Principles_6.pdf.

424 Investment guidelines may be established by the fund or the adviser and approved by the board and typically provide a set of limits on the fund's investment activities. These guidelines may be of varying degrees of specificity and typically are distinct from the fund's disclosure to investors. The rule does not require funds to establish such guidelines, but we understand that most funds do have such guidelines in place. This element would require that funds manage the risks of their derivatives transactions so that they are consistent with any such established guidelines, as well as being consistent with relevant portfolio limitations and disclosure.

425 *See, e.g.*, Comprehensive Risk Management of OTC Derivatives, *supra* note 408; Statement on best practices for managing risk in derivatives transactions, *supra* note 408; 2008 IDC Report, *supra* note 72.

426 This could also include creating maximum effective leverage limits for the fund, if such limits are determined to be useful tools for managing the risks of derivatives transactions.

also consider establishing an "approved list" of specific derivative instruments or strategies that may be used, as well as a list of persons authorized to engage in the transactions on behalf of the fund.[427] Funds may also wish to consider establishing corresponding investment size controls or limits for approved transactions across the fund, along with appropriate risk measurement monitoring mechanisms designed to prevent the fund from violating any portfolio limitations or investment guidelines, along with implementing tools to monitor such restrictions. Establishing clear risk management processes for approving exceptions to any established limits, with oversight and approval of any exceptions from senior management, generally is also a key aspect of effective risk management, and something funds may wish to consider implementing. Effective risk management generally also may include evaluation of counterparties, for example, through review of their financial position, overall trading relationship with the fund, and total credit exposure.[428] Funds may wish to consider establishing an approved list of counterparties, or trade-by-trade decision making in some cases.[429] In addition, counterparty risk mitigation also could include requirements related to the type and amount of collateral posted.

Managing derivatives transaction risk could also involve reviewing existing, and potentially establishing new, contingency plans and tools in case of adverse market or system events. This could include establishing committed reserve lines of credit, evaluating potential legal remedies in the case of counterparty default, and having robust systems (including back-ups

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427 Funds may wish to provide new instruments (or instruments newly used by a fund) additional scrutiny. *See, e.g.*, MFDF Guidance, *supra* note 423, at 8.

428 *See, e.g.*, Christina Ginfrida, *Mitigating Counterparty Risk in Derivatives Trades,* Treasury & Risk (June, 2013), a*vailable at* http://www.treasuryandrisk.com/2013/06/19/mitigating-counterparty-risk-in-derivatives-trades.

429 An important consideration may be whether a counterparty is a central counterparty or a counterparty dealing in over the counter instruments.

as appropriate) across front, mid, and back office operations. Funds may also consider establishing processes to manage the particular accounting, custody, legal, and other operational risks posed by derivatives transactions.

The element also would require policies and procedures for informing the portfolio manager or board of risks associated with the fund's derivatives transactions.[430] We believe that such communication would generally be a key part of any risk management and monitoring program, because information about relevant risks should not remain solely with the derivatives risk manager, but should be shared up the chain as needed so that appropriate action to address risks can be taken if warranted. We understand that funds today use various tools (for example, risk dashboards) to identify evolving risks that may serve as a key signal indicating when information should be provided to relevant parties. We believe that this communication requirement should help ensure that information about derivatives transactions risks is not siloed, but instead is shared with parties who can take actions as needed to mitigate risks. This requirement is also intended to encourage the derivatives risk manager to engage in communication with relevant parties on a current and ongoing basis as needed, and not limit communication solely to quarterly reports.

The potential risk management and monitoring mechanisms discussed above are just examples of the techniques funds might consider including in their policies and procedures to manage the risks of their derivatives transactions under this proposed element. To effectively manage its own particular risks, a fund generally should carefully review its current and planned use of derivatives well as any relevant limitations (including internal limitations established by

430 Proposed rule 18f-4(a)(3)(i)(B)*(ii)*.

the fund's adviser), and develop risk management tools and processes effectively tailored to its own circumstances.

We request comment on the proposed element of the program requiring funds to have policies and procedures reasonably designed to manage the risks of the derivatives transactions.

- Should we establish any additional risk management requirements within the program element itself, or should we keep it generally principles based as we are proposing? For example, should we specifically require the creation of approved transactions lists or derivative size controls? Should we require that funds use specific risk management tools such as stress testing? If so, what tools should we require?
- Should we require that a fund institute specific investment guidelines regarding its use of derivatives transactions? If so what would those guidelines be?
- Should we require the derivatives risk manager to provide material risk information to portfolio management or the board as appropriate, or would this be generally included in the quarterly reports provided by the officer to the board? If we did not include such an information requirement, would risk information potentially become stale and not be acted upon in a timely manner?

c. Segregation of Functions

We are also proposing to require, as an element of the program, that a fund have policies and procedures reasonably designed to reasonably segregate the functions associated with the program from the portfolio management of the fund.[431] We believe that independence of risk

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431 Proposed rule 18f-4(a)(3)(i)(C).

management from portfolio management should promote objective and independent risk assessment to complement and cross check portfolio management,[432] and that maintaining separation of these functions should enhance the protections provided by the program. We understand that funds today often make efforts to reasonably segregate risk management from portfolio management and believe that this proposed requirement would therefore be consistent with existing practices. Many commentators have observed that independent oversight of derivatives activities by compliance and internal audit functions is valuable.[433] Because fund management personnel may be compensated in part based on the returns of the fund they manage, the incentives of portfolio managers may not always be consistent with the restrictions imposed by a risk management program. Thus, we believe that keeping the functions separate should help mitigate the possibility that the program's effectiveness could be diminished if it were not independent of portfolio management. Separation of functions creates important checks and balances and can be instituted through a variety of methods such as independent reporting chains, oversight arrangements, or separate monitoring systems and personnel.[434]

However, this segregation of functions is not meant to indicate that the derivatives risk manager and portfolio management should be subject to a communications "firewall."[435] We

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432 *See, e.g.*, Comptroller of the Currency Administrator of National Banks, RISK MANAGEMENT OF FINANCIAL DERIVATIVES: COMPTROLLER'S HANDBOOK, (Jan. 1997), at 9 (discussing the importance of independent risk management functions in the banking context).

433 *See, e.g.*, COSO, *Internal Control Issues in Derivatives Usage, available at* http://coso.org/documents/Internal%20Control%20Issues%20in%20Derivatives%20Usage.pdf; *see also,* FSA Times Derivatives Dangers, *supra* note 408.

434 Another important segregation tool may be ensuring that the compensation of the risk management oversight personnel is not tied to or dependent on the performance of the fund. *See, e.g.*, Raffaelle Scalcione, THE DERIVATIVES REVOLUTION: A TRAPPED INNOVATION AND A BLUEPRINT FOR CHANGE (2011), at 334.

435 In particular, we recognize that this segregation requirement may pose challenges for certain entities that may have a limited number of employees. In such cases, the program should still

recognize the important perspective and insight to the fund's use of derivatives that the portfolio manager can provide and would expect that the derivatives risk manager would work closely with portfolio management as he or she implements all aspects of the program. We believe that regular communication between the risk manager and portfolio management should be a part of any well-functioning program. Indeed, as discussed above, the derivatives risk management program would require that risk management personnel monitor the risks associated with the fund's derivatives transactions and inform portfolio management (or the fund's board) regarding those risks as appropriate.

We request comment on the proposed element requiring funds to maintain controls reasonably segregating the program functions from portfolio management.

- Do commenters agree that segregation of risk management functions from portfolio management would enhance the protections provided by the proposed derivatives risk management program requirement?
- Would this element pose difficulties for particular entities, for example, funds managed by small advisers? Should we provide any additional clarification of what it means to have reasonable segregation of functions in such cases? If so, what changes should we make?
- Are there other ways to incentivize objective and independent risk assessment of portfolio strategies that we should consider?

d. Periodic Review

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have policies and procedures designed to reasonably segregate the functions of the program from fund portfolio management. As noted previously, however, the proposed rule would require reasonable segregation, not complete segregation of functions. We also note that the derivatives risk manager would not be permitted to be a portfolio manager of the fund, which we believe is likely to encourage reasonable segregation of functions as a result of such separation of roles.

The fourth element of the proposed program is that a fund would need to have policies and procedures reasonably designed to periodically (but at least annually) review and update the program, including any models (including any VaR calculation models used during the covered period), measurement tools, or policies and procedures that are part of, or used in, the program to evaluate their effectiveness and reflect changes in risks over time.[436] Under the proposed derivatives risk management program requirement, each fund would need to develop and adopt policies and procedures to review the fund's derivatives risk, tailored as appropriate to reflect the fund's particular facts and circumstances. As part of this program, funds are likely to use a variety of models, tools, and policies and procedures as part of its implementation. The derivatives markets are dynamic and evolving, and tools and processes should be reviewed and modified as appropriate.

We believe that the periodic review of a fund's derivatives risk management program is necessary to determine whether, in light of current circumstances, these risks are appropriately being addressed. The proposed program review requirement would require each fund to develop and adopt procedures to annually review and update the fund's derivatives risk management program. This review and update would need to include any models (including any VaR calculation models used during the covered period),[437] measurement tools, or policies and procedures that are part of, or used in, the program to evaluate their effectiveness and reflect changes in risks relating to the use of derivatives. However, beyond this, proposed rule 18f-4 would not include prescribed review procedures or incorporate specific developments that a fund must consider as part of its review. A fund might generally consider whether its periodic review

[436] Proposed rule 18f-4(a)(3)(i)(D).

procedures should include procedures for evaluating regulatory, market-wide, and fund-specific developments affecting its program.

We are also proposing that this periodic review take place at least annually. We believe that the program should be reviewed and updated on at least an annual basis because the risks of derivatives transactions and tools available change and evolve rapidly. An annual review is a minimum requirement, but a fund should consider whether more frequent reviews are appropriate depending on the circumstances. We expect that such a review and update should take place frequently enough to take into account the particular risks that may be presented by the fund's use of derivatives, including the potential for rapid or significant increases in risks in changing market conditions.

We request comment on the proposed element requiring funds to periodically review and update the program.

- Do commenters agree that the rule should specifically require that a fund periodically review and update the program and any tools that are used as part of the program as proposed?
- As proposed, should we require this review to take place at least annually, or should we require a more frequent review, such as quarterly (to coincide with proposed reporting to the fund's board discussed below)? Should we instead not prescribe a minimum frequency for the periodic review and update?
- Are there certain review procedures that the Commission should require and/or on

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437 Because of the importance of VaR calculations in the proposed rule for funds that operate under the risk-based portfolio limitation, the proposed element would specifically require that any VaR models used by the fund during the covered period be included as part of this periodic review and update.

which the Commission should provide guidance? Should the Commission expand its guidance on regulatory, market-wide, and fund-specific developments that a fund's review procedures might cover?

### 3. *Administration of the Program*

Proposed rule 18f-4 would expressly require a fund to designate an employee or officer of the fund or the fund's investment adviser (who may not be a portfolio manager of the fund) responsible for administering the policies and procedures of the derivatives risk management program, whose designation must be approved by the fund's board of directors, including a majority of the directors who are not interested persons of the fund.[438] We believe that having a designated individual responsible for managing the program should enhance its accountability and effectiveness. The derivatives risk manager may also have other roles, including, for example, serving as the fund's chief compliance office or chief risk manager (if it has one).[439] Under the proposed rule, the derivatives risk manager must be an employee of the fund or its investment adviser, but may not be a portfolio manager for the fund.[440] We recognize that some

438 Proposed rule 18f-4(a)(3)(ii)(C). This would differ from the approach taken in our recent liquidity rulemaking proposal, which would not require the designation of a specific person to administer the program, but would instead allow the designation of the fund's adviser or multiple employees to administer the program. We note that the derivatives risk management program condition would apply only to a limited subset of funds that choose to use derivatives to obtain exposure exceeding 50% of the fund's net assets (or that choose to use complex derivatives), while all open-end funds (other than money market funds) and ETFs would be required to have a liquidity program under proposed rule 22e-4. As noted above, we believe that the risks of derivatives transactions are complex and significant. Having a specific person designated as responsible for administering the program rather than a committee or group should help to more clearly delineate lines of responsibility and oversight over these risks for those funds that choose to engage in them.

439 *See, e.g.*, Investment Company Institute, *Chief Risk Officers in the Mutual Fund Industry: Who are they and what is their role within the organization* (2007), *available at* http://www.ici.org/pdf/21437.pdf.

440 A fund could also formally designate an employee or officers of the fund's sub-adviser to be responsible for administering the derivatives risk management program.

small advisers may have a limited number of employees or officers who are not portfolio managers of the fund. In such a case, the fund's chief compliance officer might be designated as the program's risk manager (with assistance from third parties as appropriate) or the fund or adviser may determine that they need to hire new personnel to administer the program. In any event, the derivatives risk manager should generally be sufficiently knowledgeable about the risks and use of derivatives that he or she can effectively fulfill the responsibilities of their position.

For the same reasons discussed above regarding the maintenance of controls that segregate functions of the program from portfolio management, we believe that independence of the derivatives risk manager is important for a well-functioning program.[441] If a derivatives risk manager were a person making portfolio management decisions, the risk manager may be influenced to selectively apply or otherwise weaken or not fully comply with the program's requirements if the restrictions of the program potentially conflict with the preferred investment strategy of the portfolio manager.

Unlike the chief compliance officer under rule 38a-1, proposed rule 18f-4 would not require that a derivatives risk manager only be removable by the board, nor would the board need to approve the derivatives risk manager's compensation. While we expect that a derivatives risk manager would play an important role, we do not believe that his or her removal or compensation would in all cases be so central to the fund's investment activities or compliance function to require that risk managers should generally be appointed or removed only by the board.[442]

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441 *See, e.g.*, MFDF Guidance, *supra* note 423.

442 This approach is also consistent with the designation process we recently proposed in the liquidity

We request comment on the proposed requirement that a program be administered by a derivatives risk manager.

- Under the proposed rule, the derivatives risk manager may not act as a portfolio manager of the fund. Do commenters agree that this is appropriate and would improve the effectiveness of the program? If not, why?
- Under the proposed rule, a specific person who is an employee or officer of the fund or its adviser would be designated as the risk manager. Is this appropriate? Should we instead allow the fund to designate the adviser as a whole or a group of people (such as a risk committee) as the program's risk manager?
- Is it appropriate to specify that the derivatives risk manager may not be a portfolio manager for the fund and must be an employee or officer of the fund or its adviser? Would any small fund complexes have difficulty meeting the proposed requirement?
- Rule 38a-1(c) prohibits officers, directors, and employees of the fund and its adviser from, among other things, coercing or unduly influencing a fund's CCO in the performance of their duties. Should we include such a prohibition on unduly influencing a fund's derivatives risk officer in the proposed risk management condition? Why, or why not? Should the Commission prohibit any officers, directors, or employees of a fund and its adviser from, directly or indirectly, taking any action to coerce, manipulate, mislead, or fraudulently influence the derivatives risk officer in the performance of his or her responsibilities?
- This requirement would effectively bar funds from outsourcing the administration

rulemaking proposal. *See* Liquidity Release, *supra* note 5.

of the derivatives risk manager to third parties. Is this appropriate, or should we instead allow third parties to administer the program as some funds and investment advisers do with respect to their chief compliance officer? Would allowing third parties to act as risk managers enhance the program by allowing specialized personnel to administer the program or detract from it by allowing for a risk manager who may not be as focused on the specific risks of the particular fund and its program?

- If we were not to require the independence between the derivatives risk manager and the fund's portfolio managers, how could we ensure that the program management is not unduly influenced by portfolio management personnel who may have conflicting incentives?
- Do commenters agree that it would be appropriate to require a fund to designate the fund's derivatives risk manager, subject to board approval?
- Should we require the derivatives risk manager to be removable only by the fund's board and the manager's compensation to be approved by the board as is the case with the chief compliance officer of a fund? If so why? Would such a requirement pose significant burdens on fund boards?
- Should we include any other administration requirements? For example, should we include a requirement for training staff responsible for day-to-day management of the program, or for portfolio managers, senior management, and any personnel whose functions may include engaging in, or managing the risk of, derivatives transactions? If we require such training, should that involve setting minimum qualifications for staff responsible for carrying out the requirements of

the program? Should training and education be required with respect to any new derivatives instruments that a fund may trade?

*4. Board Approval and Oversight*

Under the proposed rule, the fund's derivatives risk management program would be administered by the derivatives risk manager, with oversight provided by the board. Requiring the derivatives risk manager to be responsible for the day-to-day administration of the fund's derivatives risk management program, subject to board oversight, is consistent with the way we believe many funds currently manage derivatives risk.

We believe that boards should understand the derivatives risk management program and the risks it is designed to manage.[443] Accordingly, proposed rule 18f-4 would require each fund to obtain initial approval of its written derivatives risk management program from the fund's board of directors, including a majority of independent directors.[444] Directors, and particularly independent directors, play a critical role in overseeing fund operations, although they may delegate day-to-day management to a fund's adviser.[445] Given the board's historical oversight role, we believe it is appropriate to require a fund's board to approve the fund's derivatives risk management program. This requirement is designed to facilitate scrutiny by the board of directors of the derivatives risk management program – an area where there may potentially be

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443 *See*, *e.g.*, 2011 IDC Report, *supra* note 385, at 9; MFDF Guidance, supra note 423. *See also,* Gene Gohlke, *If I Were a Director of a Fund Investing in Derivatives-Key Areas of Risk on Which I Would Focus* (Nov. 2007), *available at* http://www.sec.gov/news/speech/2007/spch110807gg.htm.

444 In this Release, we refer to directors who are not "interested persons" of the fund as "independent directors." Section 2(a)(19) of the Investment Company Act identifies persons who are "interested persons" of a fund.

445 *See*, *e.g.*, Liquidity Release, *supra* note 5, at 175.

conflicts of interest between the investment adviser and the fund with respect to the use of derivatives by the fund.

In considering whether to approve the program or any material changes to it, boards generally should consider the types of derivatives transactions in which the fund engages or plans to engage, their particular risks, and whether the program sufficiently addresses the fund's compliance with its investment guidelines, any applicable portfolio limitation, and relevant disclosure. Boards generally should consider the adequacy of the program from time to time in light of past experience (both by the fund in particular and with market derivatives use in general) and recent compliance experiences. Boards may also wish to consider best practices used by other fund complexes, or consult with other experts familiar with derivatives risk management by similar funds or market participants. Directors may satisfy their obligations with respect to this initial approval by reviewing summaries of the derivatives risk management program prepared by the fund's derivatives risk manager, legal counsel, or other persons familiar with the derivatives risk management program. The summaries might familiarize directors with the salient features of the program and provide them with an understanding of how the derivatives risk management program addresses the fund's use of derivatives. In considering whether to approve a fund's derivatives risk management program, the board may wish to consider the nature of the fund's derivatives risk exposures. A board also may wish to consider the adequacy of the fund's derivatives risk management program in light of recent experiences regarding the fund's use of derivatives.[446]

446 *See also* Liquidity Release, *supra* note 5 (which provides similar board oversight of liquidity risk management).

Proposed rule 18f-4 also would require each fund to obtain approval of any material changes to the fund's derivatives risk management program from the fund's board of directors, including a majority of independent directors. As with the initial approval of a fund's derivatives risk management program, the requirement to obtain approval of any material changes to the fund's derivatives risk management program from the board is designed to facilitate independent scrutiny of material changes to the derivatives risk management program by the board of directors.

The fund's board would be required under the proposed rule to review a written report from the fund's derivatives risk manager, provided no less frequently than quarterly, that reviews the adequacy of the fund's derivatives risk management program and the effectiveness of its implementation.[447] We believe regular reporting to the board should assist boards in being adequately informed about the effectiveness and implementation of the program, enhancing their oversight ability.[448] To the extent that a serious compliance issue arises under the program, it should be brought to the board's attention promptly.[449] Regular reporting will also help to reduce the risk that issues are not addressed promptly and increase the likelihood that the derivatives risk manager is actively involved in addressing issues as they arise. We believe that this reporting should take place on at least a quarterly basis, rather than an annual one, in light of the significant impact that derivatives transactions can have on a fund over a short period of time.

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447 Proposed rule 18f-4(a)(3)(ii)(B).

448 The derivatives risk manager generally should consider whether significant issues should be reported to the adviser or board more quickly than in the quarterly report, for example pursuant to the requirement laid out in proposed rule 18f-4(a)(3)(i)(B)(*ii*).

449 *See* Compliance Programs of Investment Companies and Investment Advisers Release No. 2204, at n.84 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)] ("2003 Adopting Release")(noting, in the case of a rule 38a-1 compliance program, that "[s]erious compliance issues must, of course, always be brought to the board's attention promptly").

We request comment on the proposed board approval and oversight requirements.

- Should the board be required to approve the program and any material changes as proposed? If not, why? In the absence of such board approval, would a board be able to effectively oversee the adequacy of a program?
- Should we require reporting to the board about the effectiveness of the program as proposed? Should we require a frequency other than quarterly? If so, how frequent and why? Should we not require a frequency but instead require periodic reporting as appropriate?
- Instead of requiring boards to review the report, should we instead take an approach similar to rule 38a-1 and require reports to be submitted to the board?

### E. Requirements for Financial Commitment Transactions

The proposed rule also would address and limit funds' use of financial commitment transactions. The proposed rule would define a "financial commitment transaction" as any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement.[450] The requirements applicable to financial commitment transactions in the proposed rule thus would address funds' use of the trading practices described in Release 10666, as well as short sales of securities.

The proposed rule would require a fund that engages in financial commitment transactions in reliance on the rule to maintain qualifying coverage assets equal in value to the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or

[450] Proposed rule 18f-4(c)(4). The rule includes, as a similar agreement, an agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner.

deliver under each of its financial commitment transactions.[451] The proposed rule thus is designed to require the fund to maintain qualifying coverage assets equal in value to the fund's full obligations under its financial commitment transactions. Because in many cases the timing of the fund's payment obligations under a financial commitment transaction may be specified under the terms of the transaction or the fund may otherwise have a reasonable expectation regarding the timing of the fund's payment obligations with respect to its financial commitment transactions, the proposed rule would allow the fund to maintain as qualifying coverage assets certain other assets in addition to cash and cash equivalents, as generally required for derivatives transactions.[452] Qualifying coverage assets for each financial commitment transaction would need to be identified on the books and records of the fund at least once each business day.

By requiring the fund to maintain qualifying coverage assets to cover the fund's full potential obligation under its financial commitment transactions, the proposed rule generally would take the same approach to these transactions that we applied in Release 10666, with some modifications. As we discussed above in section III.A, requiring a fund to segregate assets equal in value to the fund's full obligations under financial commitment transactions may be an effective way both to impose a limit on the amount of leverage a fund could obtain through those transactions, and to require the fund to have adequate assets to meet its obligations. The asset segregation requirement in the proposed rule is designed to limit the amount of leverage the fund could obtain through financial commitment transactions because the fund could not incur obligations under those transactions in excess of the fund's qualifying coverage assets. This would limit a fund's ability to incur obligations under financial commitment transactions to an

[451] Proposed rule 18f-4(b)(1), (c)(5).

[452] Proposed rule 18f-4(c)(8)(iii) (defining "qualifying coverage assets" for purposes of financial commitment transactions).

amount not greater than the fund's net assets. This approach also is designed to help the fund to have adequate assets to meet its obligations under financial commitment transactions by requiring the fund to have qualifying coverage assets equal in value to those obligations.

Under the proposed rule, the fund's board of directors (including a majority of the directors who are not interested persons of the fund) would be required to approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets. We believe that requiring the fund's board to approve the policies and procedures, including a majority of the fund's independent directors, appropriately would focus the board's attention on the fund's management of its obligations under financial commitment transactions and the fund's use of the exemption provided by the proposed rule. We believe that requiring the fund's board to approve these policies and procedures, in conjunction with the board's oversight of the fund's investment adviser more generally, would be an appropriate role for the board.[453]

### *1. Coverage Amount for Financial Commitment Transactions*

Under the proposed rule, a fund would be required to maintain qualifying coverage assets for each financial commitment transaction with a value equal to at least the amount of the financial commitment obligation associated with the transaction.[454] The proposed rule would define the term "financial commitment obligation" to mean the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction.[455] Thus, for example, if a fund commits, conditionally or unconditionally, to purchase a security for a stated price at a later time under a firm or standby

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[453] Other exemptive rules under the Act similarly require the fund's board to take certain actions in order for the fund to rely on the exemption provided by the rule. *See, e.g.*, rules 2a-7, 10f-3, 17a-7, and 18f-3.

[454] Proposed rule 18f-4(b)(1).

[455] Proposed rule 18f-4(c)(5).

commitment agreement or similar agreement, the fund would be required to maintain qualifying coverage assets equal in value to the stated purchase price.[456]

In addition, where the fund is conditionally or unconditionally obligated to deliver a particular asset, the financial commitment obligation under the proposed rule would equal the value of the asset, determined at least once each business day.[457] Thus, for example, if a fund commits to return a security at a later time under a short sale borrowing, the fund would be required to maintain qualifying coverage assets equal to the value of the security, determined at least once each business day. If the fund owns the security it would be required to deliver under the short sale borrowing, the fund would satisfy the proposed rule's asset segregation requirement by segregating that particular security for the same reasons we discuss above in section III.C.2.b.[458]

The proposed rule would require the fund to maintain qualifying coverage assets to cover the full amount of the fund's obligations under its financial commitment transactions, rather than a mark-to-market and risk-based coverage amount as proposed for derivatives transactions, because a fund may in many cases be required to fulfill its full obligation under a financial commitment transaction as compared to a derivatives transaction. For example, if a fund enters into a firm commitment agreement under which it is obligated to purchase a security in the future,

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456 Similarly, if a fund commits, conditionally or unconditionally, to pay cash or other assets as an additional loan or contribution to an existing portfolio company under an agreement, the fund would be required to maintain qualifying coverage assets equal in value to the stated commitment amount.

457 Proposed rule 18f-4(c)(5).

458 Proposed rule 18f-4(b)(1), (c)(5), (c)(8)(ii). As described in more detail below, if the fund has pledged assets with respect to the short sale borrowing and such assets could be expected to satisfy the fund's obligation under the transaction, the fund could also satisfy the proposed rule's asset segregation requirement by segregating such pledged assets. See proposed rule 18f-4(c)(8)(iii).

the fund is required under the agreement, and must be prepared, to have sufficient assets to complete the transaction. Similarly, if a fund borrows a security from a broker as part of a short sale borrowing, the fund is obligated to return the security to the broker at the termination of the transaction and must be prepared to meet this obligation, either by owning the security or having assets available to purchase it in the market. By contrast, under many types of derivatives transactions, a fund would generally not expect to make payments or deliver assets equal to the full notional amount.

We recognize that certain financial commitment transactions, such as standby commitment agreements, are contingent in nature and may not always require a fund to fulfill its full potential obligation under the transaction. We also recognize that certain derivatives transactions, such as written options, could result in a fund having to fulfill its full potential obligation under the contract. On balance, however, we believe it would be appropriate to require a fund to maintain qualifying coverage assets to cover its financial commitment obligations, as proposed, to require the fund to have assets to meet its financial commitment obligations. We also note that, as discussed in more detail below, the proposed rule would permit a fund to use assets other than cash and cash equivalents as qualifying coverage assets for financial commitment transactions. In this way the proposed rule is designed both to require a fund to have assets to meet its financial commitment obligations and to address concerns that might be raised if the fund were required to maintain cash and cash equivalents for the fund's longer-term financial commitment obligations. We also believe that this approach would be consistent with funds' current practices in that we understand that funds that rely on Release 10666 when entering into financial commitment transactions generally segregate assets to cover the funds' full potential obligations under these transactions.

In addition, by requiring the fund to maintain qualifying coverage assets equal in value to the fund's aggregate financial commitment obligations, the proposed rule also would impose a limit on the amount of leverage a fund could obtain through financial commitment transactions. This is because a fund relying on the rule would not be permitted to incur obligations under financial commitment transactions in excess of the fund's qualifying coverage assets. As noted in section III.C.2.c, the total amount of a fund's qualifying coverage assets could not exceed the fund's net assets.[459] As a result, the fund's financial commitment obligations could not exceed the fund's net assets under the proposed rule.

We have proposed to limit the total amount of fund assets available for use as qualifying coverage assets because, absent this provision, the proposed rule would not impose an effective limit on the amount of leverage a fund could obtain through financial commitment transactions. This is because, in addition to creating a liability for the fund, some financial commitment transactions also generate proceeds that increase the total assets of the fund. If the total amount of a fund's qualifying coverage assets was not reduced to reflect the fund's liability from these transactions, the requirement to maintain qualifying coverage assets would not provide an effective limit on the fund's ability to enter into those transactions because a financial commitment transaction can generate fund assets that could otherwise be used as qualifying coverage assets.

Take, for example, a fund that has $100 in assets and no liabilities or senior securities outstanding. The fund then borrows a security from a broker and sells it short, generating $10 on the sale. The fund would then have $110 in total assets and a corresponding liability of $10. If the fund were not required to reduce the total amount of its qualifying coverage assets by the

459 Proposed rule 18f-4(c)(8).

amount of the liability from this transaction, the fund would have $110 in total assets that potentially could be used as qualifying coverage assets if they otherwise met the rule's requirements for qualifying coverage assets; the fund's selling a security short could be viewed as increasing the fund's ability to engage in transactions requiring asset segregation under the proposed rule because the transaction itself generated assets. The proposed rule would require the fund to reduce the amount of otherwise available qualifying coverage assets by the amount of the liability from the short sale in this example (i.e., $10) so that the requirement to maintain qualifying coverage assets would impose an effective limit on the amount of leverage a fund could obtain through financial commitment transactions.[460]

Finally, as noted above, a fund's qualifying coverage assets for its financial commitment transactions, like the qualifying coverage assets for the fund's derivatives transactions, would be required to be identified on the fund's books and records and determined at least once each business day.[461] This requirement is designed so that the fund's assessments of the extent of its financial commitment obligations and the eligibility of its segregated assets as qualifying coverage assets (discussed below) remain reasonably current because the value of certain qualifying coverage assets and the amount of certain financial commitment obligations may fluctuate on a daily basis. Based on staff experience, we believe that this frequency of

460 In addition, and as discussed in more detail in section III.C.2.c, the limit on the total amount of a fund's qualifying coverage assets also is designed to prohibit a fund from entering into financial commitment transactions or issuing other senior securities and then using the proceeds of such leveraging transactions as assets that would then support an additional layer of leverage through financial commitment transactions or derivatives transactions under the proposed rule.

461 Proposed rule 18f-4(b)(1).

determination would be consistent with funds' current practices because funds that engage in financial commitment transactions today do so in reliance on Release 10666."[462]

We request comment on all aspect of the proposed rule's requirement that a fund maintain assets in respect of the financial commitment obligation for its financial commitment transactions and the requirement that the fund's qualifying coverage assets be identified on the fund's books and records and determined at least once each business day.

- The proposed rule's approach to financial commitment transactions, as discussed above, is based on the approach we took in Release 10666 for financial commitment transactions and is designed to impose a limit on the amount of leverage a fund could obtain through those transactions, and to require the fund to have adequate assets to meet its obligations. Do commenters agree with the proposed rule's approach to financial commitment transactions? Do commenters believe that it would be effective in addressing concerns about leverage and adequacy of assets in connection with a fund's use of financial commitment transactions?
- Is the definition of financial commitment transaction obligation sufficiently clear to allow a fund to determine the amount of assets necessary to comply with the rule? Does the definition adequately capture all of a fund's potential obligations under a financial commitment transaction?
- Should we continue to require funds to segregate their full potential obligation under financial commitment transactions, consistent with Release 10666? Or, should we instead treat financial commitment transactions similar to derivatives

462 *See* Release 10666, *supra* note 20, at discussion of "Segregated Account."

transactions and require funds to segregate the mark-to-market coverage amount and a risk-based coverage amount for each financial commitment transaction? If we were to take this approach, are there types of financial commitment transactions for which it may be difficult to determine a mark-to-market coverage amount because, for example, there are not market prices available for the transactions?

- Under the proposed rule, all financial commitment transactions would be subject to the same asset segregation requirement, regardless of whether the fund's obligation under the transaction is conditional or whether the amount of the financial commitment obligation could fluctuate over time. Should we treat conditional financial commitment transactions, such as standby commitment agreements, differently than financial commitment transactions where the obligations are not conditional? If so, how should the asset segregation requirement differ? Should these conditional financial commitment transactions be treated like derivatives transactions? Should we treat short sales, which have a financial commitment obligation that can vary over time, differently than other financial commitment transactions that have a fixed financial commitment obligation amount? If so, how should the asset segregation requirement differ? Should short sales be treated like derivatives transactions and require a risk-based coverage amount or some other amount designed to address future losses?
- The asset segregation requirement in the proposed rule would effectively impose a limit on the fund's ability to enter into financial commitment transactions by limiting the total amount of a fund's qualifying coverage assets and providing that

qualifying coverage assets shall not exceed the fund's net assets. Does the proposed rule appropriately limit the extent to which funds should be permitted to enter into financial commitment transactions? Should the proposed rule include a separate portfolio limitation, similar to the 150% portfolio limitation on derivatives transactions in the exposure-based portfolio limit, rather than limiting the extent to which a fund could incur obligations under financial commitment transactions indirectly through the asset segregation requirement? If so, should that limit be 100% of the fund's net assets (consistent with the proposed rule's limit on the total amount of qualifying coverage assets)? Should it be lower, such as 50% of the fund's net assets, or higher, such as the 150% limitation applicable to derivatives transactions under the exposure-based portfolio limit? Are there other limits, higher or lower, that would be appropriate?

- The proposed rule would require a fund to identify and determine its qualifying coverage assets for its financial commitment obligations at least once each business day. Should the proposed rule instead require the fund to identify and determine these qualifying coverage assets more or less frequently?

### 2. *Qualifying Coverage Assets for Financial Commitment Transactions*

Under the proposed rule, "qualifying coverage assets" in respect of a financial commitment transaction would be fund assets that are: (1) cash and cash equivalents; (2) with respect to any financial commitment transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset; or (3) assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board of directors.[463] The total amount of a fund's qualifying coverage assets could not exceed the fund's net assets.[464]

For financial commitment transactions, the proposed rule would permit a fund to maintain assets in addition to cash and cash equivalents, as proposed for derivatives transactions, as qualifying coverage assets for the fund's financial commitment transactions.[465] This is because we understand that funds use financial commitment transactions for a variety of financial and investment purposes, including obtaining financing for investments acquired (or to be acquired) by the fund and establishing contractual relationships under which the fund agrees to make or acquire loans, debt securities or additional interests in portfolio companies in the future. In many cases, the timing of the fund's payment obligations may be specified under the terms of the financial commitment or the fund may otherwise have a reasonable expectation regarding the timing of the fund's payment obligations with respect to its financial commitment transactions. In addition, certain financial commitment transactions require a fund to pledge assets having an aggregate value that is greater than the financial commitment obligation and, given that the amount and value of these assets will have been evaluated both by the fund and its counterparty, we believe that such assets would generally be expected to satisfy the fund's obligation under such financial commitment transaction unless there subsequently occurs a material reduction in the value of such assets.

463 Proposed rule 18f-4(c)(8).

464 Proposed rule 18f-4(c)(8). In addition, qualifying coverage assets used to cover a financial commitment transaction could not also be used to cover a derivatives transaction. Proposed rule 18f-4(c)(8).

465 Proposed rule 18f-4(c)(8).

The proposed rule therefore would permit a fund to maintain assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay its financial commitment obligation or that have been pledged with respect to a financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board of directors.[466] For example, if a fund enters into a firm commitment agreement whereby the fund agrees to purchase a security from a counterparty at a future date and at a stated price, the fund would know at the outset of the transaction the date on which the obligation is due and the full amount of the obligation. Rather than being required to maintain cash and cash equivalents equal in value to the amount of this obligation—which the fund may not be required to pay for some time—the proposed rule would permit the fund to maintain assets that are convertible to cash or that will generate cash prior to the date on which the fund can be expected to be required to pay such obligation, determined in accordance with board-approved policies and procedures.

In this example, if the purchase price of the firm commitment is $100 and the transaction will be completed on a fixed date, the fund, if consistent with its policies and procedures relating to qualifying coverage assets, could segregate a fixed-income security with a value of $100 or more that would pay $100 or more upon maturity and would mature in time for the fund to use the principal payment to complete the firm commitment transaction. As another example, the fund could, if consistent with its policies and procedures relating to qualifying coverage assets,

466 Proposed rule 18f-4(c)(8)(iii). As noted above, where the fund is conditionally or unconditionally obligated to deliver a particular asset, the fund also could satisfy the proposed rule's asset segregation requirements by segregating that particular asset. Proposed rule 18f-4(c)(8)(ii).

segregate a fixed-income security with a value of $100 or more that would generate $100 or more in interest payments that the fund could use to complete the firm commitment agreement.

Qualifying coverage assets under the proposed rule include assets that are convertible to cash or able to generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation.[467] Where the fund can be expected to pay the obligation on a short-term basis, the assets maintained by the fund as qualifying coverage assets also would have to be convertible to cash or able to generate cash on a short-term basis. For example, if the fund has entered into a standby commitment agreement and the fund could be expected to be required to pay the purchase price under the agreement on a short-term basis, the fund would need to segregate assets that could be convertible to cash or able to generate cash in a short period of time to enable the fund to meet its expected obligation. We would expect these assets to be highly liquid assets given the short-term nature of the fund's obligation under the transaction and the proposed rule's requirement that qualifying coverage assets be convertible to cash or generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation.

The proposed rule would require that an asset's convertibility to cash or the ability to generate cash, and the date on which the fund can be expected to be required to pay the financial commitment obligation, be determined in accordance with policies and procedures approved by the fund's board of directors.[468] By requiring funds to establish appropriate policies and procedures, rather than prescribing specific segregation methodologies, the proposed rule is

467 Proposed rule 18f-4(c)(8).

468 Proposed rule 18f-4(c)(8).

designed to allow funds to assess and determine when they can be required to pay financial commitment obligations and their assets' convertibility to cash or ability to generate cash based on the funds' specific financial commitment transactions and investment strategies. As with respect to the determination of risk-based coverage amounts for derivatives transactions, we believe that funds are best situated to evaluate their obligations under their financial commitment transactions and the eligibility of their assets to be used as qualifying coverage assets based on an assessment of their own particular facts and circumstances.

We note that, if we adopt proposed rule 22e-4, funds subject to that rule already would be considering their assets' convertibility to cash in order to comply with rule 22e-4, as explained in more detail in the Liquidity Release.[469] In classifying and reviewing the liquidity of portfolio positions, proposed rule 22e-4 would require the fund to consider the number of days within which the fund's position in a portfolio asset (or portions of a position in a particular asset) would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale.[470] Proposed rule 22e-4 would require the fund to consider certain specified factors in classifying the liquidity of its portfolio positions.[471] Funds undertaking this analysis for purposes of rule 22e-4 thus already would have considered their assets'

469 Proposed rule 22e-4(b)(2)(i).

470 Liquidity Release, *supra* note 5.

471 Liquidity Release, *supra* note 5. Specifically, proposed rule 22e-4 would require the fund to consider the following factors, to the extent applicable: (i) existence of an active market for the asset, including whether the asset is listed on an exchange, as well as the number, diversity, and quality of market participants; (ii) frequency of trades or quotes for the asset and average daily trading volume of the asset (regardless of whether the asset is a security traded on an exchange); (iii) volatility of trading prices for the asset; (iv) bid-ask spreads for the asset; (v) whether the asset has a relatively standardized and simple structure; (vi) for fixed income securities, maturity and date of issue; (vii) restrictions on trading of the asset and limitations on transfer of the asset; (viii) the size of the fund's position in the asset relative to the asset's average daily trading volume and, as applicable, the number of units of the asset outstanding; and (ix) relationship of the asset to another portfolio asset. *See Id.*, at section III.A.

convertibility to cash and could use this analysis (and related policies and procedures) for purposes of rule 18f-4.

Although not every fund that would be subject to proposed rule 18f-4 would be subject to proposed rule 22e-4, to the extent that fund advisers and third-party service providers develop methodologies or other tools for assessing positions' convertibility to cash in a manner consistent with proposed rule 22e-4, we anticipate that such tools could be used by all funds subject to proposed rule 18f-4 in assessing convertibility to cash for purposes of rule 18f-4. Thus, closed-end funds and BDCs, which are not within the scope of proposed rule 22e-4 but which may enter into financial commitment transactions, could nevertheless employ tools that were developed in response to proposed rule 22e-4 in determining whether an asset is a qualifying coverage asset.[472] In sum, although proposed rule 18f-4 would not require the fund's policies and procedures to include the factors specified in proposed rule 22e-4, funds may find it efficient to consider those factors and methodologies and tools designed to address them.

The proposed rule would also allow a fund to use, as qualifying coverage assets, assets that have been pledged with respect to a financial commitment obligation and can be expected to

[472] Money market funds also are not proposed to be subject to the requirements of proposed rule 22e-4 because they are subject to extensive requirements concerning the liquidity of their portfolio assets under rule 2a-7. *See* Liquidity Release, *supra* note 138. Under rule 2a-7, money market funds are required to limit their investments to short-term, high-quality debt securities that fluctuate very little in value under normal market conditions. Money market funds thus do not engage in derivatives transactions, but may enter into certain financial commitment transactions to the extent permitted under rule 2a-7. Although money market funds could choose to evaluate their assets' convertibility to cash using the factors in proposed rule 22e-4, we generally would expect that they would not need to do so for purposes of proposed rule 18f-4 because we expect that a money market fund, in order to comply with the conditions of rule 2a-7 (including the rule's liquidity requirements and limitations on the maturity of portfolio assets), already would be evaluating when its assets will generate cash (or be convertible to cash) and when it could be expected to pay its financial commitment obligations.

satisfy such obligation.[473] For example, assets that are pledged by a fund to its broker in connection with a short sale borrowing that can be expected to satisfy the fund's obligations under such transaction could, if consistent with the fund's policies and procedures relating to qualifying coverage assets, be segregated on the fund's books and records as qualifying coverage assets for such short sale transaction. Assets that a fund has transferred to its counterparty in connection with a reverse repurchase agreement could be regarded as having been pledged by the fund for purposes of paragraph (c)(8)(iii) of the proposed rule. If such assets can be expected to satisfy the fund's obligations under such transaction, the fund could, if consistent with its policies and procedures relating to qualifying coverage assets, segregate such assets on its books and records as qualifying coverage assets for such transaction.

We request comment on all aspects of the proposed rule's requirements for qualifying coverage assets for financial commitment transactions.

- Do commenters agree that it is appropriate to permit a fund to maintain assets in addition to cash and cash equivalents as qualifying coverage assets for the fund's financial commitment transactions? Should we, instead, require funds to use cash and cash equivalents, as proposed for derivatives transactions, or otherwise specify the types or liquidity profiles of assets that may be used? Should we specify that certain types of assets should not be included as qualifying coverage assets?
- Do commenters agree that, in many cases, the timing of the fund's payment obligations may be specified under the terms of the financial commitment or the fund may otherwise have a reasonable expectation regarding the timing of the

473 Proposed rule 18f-4(c)(8)(iii).

fund's payment obligations with respect to its financial commitment transactions? If so, do commenters agree that the proposed rule appropriately recognizes this aspect of many types of financial commitment transactions by permitting a fund to segregate assets that are convertible to cash or that will generate cash prior to the date on which the fund can be expected to be required to pay its financial commitment obligations, determined in accordance with board-approved policies and procedures?

- Under the proposed rule, qualifying coverage assets in respect of a financial commitment transaction would include fund assets that have been pledged by the fund with respect to the financial commitment obligation and can be expected to satisfy such obligation. Do commenters agree that such assets should be considered qualifying coverage assets? Does the proposed rule appropriately describe such assets? Are there additional requirements that we should impose on the use of such assets as qualifying coverage assets?
- The proposed rule would require that an asset's convertibility to cash or the ability to generate cash, and the date on which the fund can be expected to be required pay the financial commitment obligation, be determined in accordance with policies and procedures approved by the fund's board of directors. Do commenters agree that it is appropriate to allow funds to assess and determine when they can be expected to be required to pay financial commitment obligations and their assets' convertibility to cash or ability to generate cash based on the funds' specific financial commitment transactions and investment strategies?

- The proposed rule would not specify the particular factors that must be included in a fund's policies and procedures for purposes of determining an asset's convertibility to cash or the ability to generate cash, and the date on which the fund can be expected to be required to pay the financial commitment obligation. Are there particular factors we should specify in any final rule? We noted above that, in developing these policies and procedures, a fund could consider the factors specified in proposed rule 22e-4. Should we specifically require that a fund's policies and procedures include the factors specified in rule 22e-4 if we adopt that rule? If so, should only those funds subject to the requirements of proposed rule 22e-4 be required to include those factors? Should we specify additional factors? If so, what factors should be specified?
- The proposed rule would allow a fund to segregate as qualifying coverage assets any assets that are convertible to cash or that will generate cash equal in amount equal to the financial commitment obligation prior to the date on which the fund can be expected to be required to pay such obligation. Should we instead allow a fund to segregate specific types of assets subject to a haircut? If so, how should we determine the appropriate haircut? For example, should we incorporate the haircuts described in the SEC's proposed rule on Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers?[474] Or should we incorporate the haircut schedule included in the rules adopted by the

[474] *See* Margin and Capital Proposing Release, *supra* note 363.

banking regulators for covered swap entities?[475] Is there a different haircut schedule that would be more appropriate for the proposed rule?

### F. Recordkeeping

Proposed rule 18f-4 also would include certain recordkeeping requirements relating to the fund's selection of a portfolio limitation; its compliance with the other requirements of the proposed rule; and if the fund is required to implement a formalized derivatives risk management program, records of the program's policies and procedures, and any materials provided to the board of directors related to its operation.[476] All the records would be required to be kept for 5 years (the first 2 years in an easily accessible place).[477]

First, the proposed rule would require a fund to maintain a record of each determination made by the fund's board that the fund will comply with one of the portfolio limitations under the proposed rule, which would include the fund's initial determination as well as a record of any determination made by the fund's board to change the portfolio limitation.[478] Such a record should allow our examiners to better evaluate compliance with the proposed exemptive rule.

475 *See* Prudential Regulator Margin and Capital Adopting Release, *supra* note 160.

476 Proposed rule 18f-4(a)(6).

477 The proposed recordkeeping time period is consistent with the retention periods in rule 38a-1 and proposed rule 22e-4. As we explained in the Liquidity Release with respect to proposed rule 22e-4, we believe consistency in these retention periods is appropriate because funds currently have program-related recordkeeping procedures in place incorporating a five-year retention period, which we believe would lessen the compliance burden to funds slightly, compared to choosing a different retention period, such as the six-year recordkeeping retention period under rule 31a-2 under the Act. Taking this into account, we believe a five-year retention period is a sufficient period of time for our examination staff to evaluate whether a fund is in compliance (and has been in compliance) with the proposed rule and anticipate that such information would become less relevant if extended beyond a five-year retention period. Furthermore, we believe that the proposed five-year retention period appropriately balances recordkeeping-related burdens on funds. *See* Liquidity Release, *supra* note 5, concerning the five-year retention periods included in proposed rule 22e-4.

478 *See* proposed rule 18f-4(a)(6)(i). The fund would be required to maintain this record for a period of not less than five years (the first two years in an easily accessible place) following each

Second, the proposed rule would require the fund to maintain certain records so that the fund's ongoing compliance with the conditions of the proposed rule can be evaluated by our examiners or the fund's board or compliance personnel. Specifically, the fund would be required to maintain a written copy of the policies and procedures approved by the board regarding the fund's maintenance of qualifying coverage assets, as required under the proposed rule.[479] The fund also would be required to maintain a written record demonstrating that immediately after the fund entered into any senior securities transaction, the fund complied with the portfolio limitation applicable to the fund immediately after entering into the senior securities transaction, reflecting the fund's aggregate exposure, the value of the fund's net assets and, if applicable, the fund's full portfolio VaR and its securities VaR.[480]

The fund also would be required to maintain written records reflecting the fund's mark-to-market and risk-based coverage amounts and the fund's financial commitment obligations, and identifying the qualifying coverage assets maintained by the fund to cover these amounts.[481] For derivatives transactions, the fund would be required to maintain written records identifying the qualifying coverage assets maintained by the fund to cover the aggregate amount of its mark-to-market and risk-based coverage amounts—rather than identifying the qualifying coverage

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determination.

479 *See* proposed rule 18f-4(a)(6)(ii) (derivatives transactions); proposed rule 18f-4(b)(3) (financial commitment transactions). The fund would be required to maintain these policies and procedures that are in effect, or at any time within the past five years were in effect, in an easily accessible place.

480 *See* proposed rule 18f-4(a)(6)(iv). The fund would be required to maintain this record for a period of not less than five years (the first two years in an easily accessible place) following each senior securities transaction.

481 *See* proposed rule 18f-4(a)(6)(v); proposed rule 18f-4(b)(3)(ii). The fund would be required to determine these amounts and identify qualifying coverage assets at least once each business day, and would be required to maintain these records for a period of not less than five years (the first two years in an easily accessible place).

assets maintained in respect of each specific derivatives transaction—because the proposed rule generally would require the fund to maintain cash and cash equivalents for its derivatives transactions.[482] For financial commitment transactions, the fund would be required to maintain written records identifying the specific qualifying coverage assets maintained by the fund to cover each financial commitment transaction in order to allow our examination staff to evaluate whether, as required under the proposed rule, the qualifying coverage assets maintained for specific financial commitment transactions are assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with the fund's policies and procedures.[483]

Finally, the proposed rule would require a fund to maintain records relating to the derivatives risk management program, if the fund is required to adopt and implement a derivatives risk management program.[484] The proposed rule would require funds to maintain a written copy of the policies and procedures approved by the board.[485] It would also require funds to maintain records of any materials provided to the board in connection with its approval of the program, as well as any written reports provided to the board relating to the program[486] and

482 *See* proposed rule 18f-4(a)(6)(v).

483 *See* proposed rule 18f-4(b)(3)(ii).

484 *See* proposed rule 18f-4(a)(6)(iii).

485 *See* proposed rule 18f-4(a)(6)(iii)(A). The fund would be required to maintain a written copy of the policies and procedures that are in effect, or at any time within the past five years were in effect, in an easily accessible place.

486 *See* proposed rule 18f-4(a)(6)(iii)(B). The fund would be required to maintain these records for at least five years after the end of the fiscal year in which the documents were provided to the fund's board, the first two years in an easily accessible place.

records documenting periodic updates and reviews required as part of the risk management program.[487] Such records should serve to provide data about the operation of a fund's program to better allow our examiners and compliance personnel to evaluate compliance with the conditions of the proposed rule.

We request comment on the proposed rule's recordkeeping requirements.

- Should we require such recordkeeping provisions? Are there any other records relating to a fund's senior securities transactions that a fund should be required to maintain?
- The proposed rule's recordkeeping requirements generally are designed to allow our examiners or the fund's board or compliance personnel to evaluate the fund's ongoing compliance with the proposed rule's conditions. Do commenters believe that the proposed rule's recordkeeping requirements would appropriately balance recordkeeping-related burdens on funds? Are there feasible alternatives to the proposed recordkeeping requirements that would minimize recordkeeping burdens, including the costs of maintaining the required records?
- We specifically request comment on any alternatives to the proposed recordkeeping requirements that would minimize recordkeeping burdens on funds, on the utility and necessity of the proposed recordkeeping requirements in

[487] Specifically, the fund would be required to maintain records documenting the periodic reviews and updates conducted in accordance with paragraph (a)(3)(i)(D) of the proposed rule (including any updates to any VaR calculation models used by the fund and the basis for any material changes thereto), for a period of not less than five years (the first two years in an easily accessible place) following each review or update. *See* Proposed rule 18f-4(a)(6)(iii)(C). We note that, because of the importance of VaR models under the rule, this provision would require funds to maintain records explaining the basis for any material changes to the VaR calculation models used during the covered period.

relation to the associated costs and in view of the public benefits derived, and on the effects that additional recordkeeping requirements would have on funds' internal compliance policies and procedures. Are the record retention time periods that we have selected appropriate? Should we require records to be maintained for a longer or shorter period? If so for how long?

### G. Amendments to Proposed Forms N-PORT and N-CEN

On May 20, 2015, in an effort to modernize and enhance the reporting and disclosure of information by investment companies, we issued a series of proposals, including proposals for two new reporting forms. First, our proposal would require registered management investment companies and ETFs organized as unit investment trusts, other than registered money market funds or small business investment companies, to electronically file with the Commission monthly portfolio investment information on proposed Form N-PORT.[488] As we discussed in the Investment Company Reporting Modernization Release, we believe that the information that would be filed on proposed Form N-PORT would enhance the Commission's ability to effectively oversee and monitor the activities of investment companies in order to better carry out its regulatory functions. We also stated that we believe that the information on proposed Form N-PORT would allow investors and other potential users to better understand investment strategies and risks, and help investors make more informed investment decisions.[489]

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488 Submissions on Form N-PORT would be required to be submitted no later than 30 days after the close of each month. Only information reported for the third month of each fund's fiscal quarter on Form N-PORT would be publicly available, and such information would not be made public until 60 days after the end of the third month of the fund's fiscal quarter. *See* Investment Company Reporting Modernization Release, *supra* note 138.

489 *See id.*

Among other things, proposed Form N-PORT would require funds to disclose certain risk metrics – specifically, the delta for derivatives instruments with optionality,[490] as well as the portfolio's interest rate risk (DV01)[491] and credit spread risk (SDV01/CR01/CS01).[492] As we stated in the Investment Company Reporting Modernization Release, disclosure of delta – a measure of the sensitivity of an option's value to changes in the price of the referenced asset – would provide the Commission, investors, and other potential users with an important measurement of the impact, on a fund or group of funds that hold options on an asset, of a change in such asset's price. Moreover, disclosure of delta would assist the Commission and others with measuring exposure to leverage through options, which would allow the Commission, investors, and other potential users to better understand the risks that the fund faces as asset prices change, because the use of this type of leverage can magnify losses or gains in assets.

Second, all registered investment companies, including money market funds but excluding face amount certificate companies, would be required to file annual reports on proposed Form N-CEN.[493] Proposed Form N-CEN would require these registered investment companies to provide census-type information that would assist our efforts to modernize the reporting and disclosure of information by registered investment companies and enhance the staff's ability to carry out its regulatory functions, including risk monitoring and analysis of the industry.[494] Among other things, proposed Form N-CEN would require funds to report whether

490 *See* Item C.11.c.iii.1 of proposed Form N-PORT.

491 *See* Item B.3.a of proposed Form N-PORT.

492 *See* Item B.3.b of proposed Form N-PORT.

493 *See* Investment Company Reporting Modernization Release, *supra* note 138.

494 *Id.*

they relied upon certain enumerated rules under the Act during the reporting period.[495] We proposed to collect this information to better monitor reliance on exemptive rules and assist us with our accounting, auditing and oversight functions, including, for some rules, compliance with the Paperwork Reduction Act.[496]

### 1. *Reporting of Risk Metrics by Funds That are Required to Implement a Derivatives Risk Management Program*

In the Investment Company Reporting Modernization Release, we requested comment on our proposal to require funds to report on Form N-PORT certain portfolio- and position-level risk metrics. We also requested comment on additional risk metrics such as gamma, which enables more precise position-level estimation of sensitivity to underlying price movements, and vega, which provides position-level sensitivity to volatility. The proposal requested comment on whether gamma and vega would enhance the utility of the derivatives information reported in Form N-PORT and the costs and burdens to funds and benefits to investors and other potential users of requiring funds to report such risk metrics.

We received several comment letters relating to our proposal to require funds to report certain portfolio- and position-level risk metrics. Some commenters reflected positively on our proposal, noting that risk metrics could allow the Commission to better understand the risks associated with investments in derivatives.[497] However, another commenter questioned the

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495 Item 31 of proposed Form N-CEN.

496 *See* Investment Company Reporting Modernization Release, *supra* note 138, at Part II.E.4.c.iv.

497 *See, e.g.*, Comment Letter of CFA Institute on Investment Company Reporting Modernization (Aug. 10, 2015) (File No. S7-08-15), *available at* http://www.sec.gov/comments/s7-08-15/s70815-228.pdf, at 6-7; Comment Letter of Interactive Data Pricing and Reference Data LLC on Investment Company Reporting Modernization (Aug. 10, 2015) (File No. S7-08-15), *available at* http://www.sec.gov/comments/s7-08-15/s70815-329.pdf, at 1, 9-11; Comment Letter of State Street Corporation on Investment Company Reporting Modernization (Aug. 11, 2015) (File No. S7-08-15), *available at* http://www.sec.gov/comments/s7-09-15/s70915-27.pdf, at 3-4 (specifically recommending, among other risk metrics, that Form N-PORT require disclosure of

utility of reporting risk metrics, such as delta, given the time-lag associated with reporting on Form N-PORT.[498] Others expressed concern with making specific risk metrics public, as, given the inherent subjectivity of computing risk metrics, disclosure could be of limited utility and potentially confusing for investors.[499]

We recognize that collecting and reporting alternative risk metrics, such as vega and gamma, could be more burdensome than reporting delta only. However, we believe that requiring funds to report information about the fund's exposures with metrics such as vega and gamma would assist the Commission in better assessing the risk in a fund's portfolio. In consideration of the additional burdens of reporting selected risk metrics to the Commission and the benefits of more complete disclosure of a fund's risks, we are proposing to limit the reporting of vega and gamma to only those funds that are required to implement a formalized derivatives risk management program as required by proposed rule 18f-4(a)(3).[500] Our reasons for limiting the reporting of vega and gamma are two-fold: First, we understand that there are added burdens to reporting risk metrics and we are therefore proposing to limit the reporting of these risk

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vega); Comment Letter of Pioneer Investments (Aug. 11, 2015) (File No. S7-08-15), *available at* http://www.sec.gov/comments/s7-08-15/s70815-302.pdf, at 13 (supporting the Commission's desire to standardize disclosure and increase transparency regarding a fund's derivative usage, and recommending that derivative reporting be subject to a de minimis threshold).

498 *See*, *e.g.*, Comment Letter of Dreyfus Corporation on Investment Company Reporting Modernization (Aug. 11, 2015) (File No. S7-08-15), *available at* http://www.sec.gov/comments/s7-08-15/s70815-333.pdf, at 3, 10.

499 *See*, *e.g.*, Comment Letter of Investment Company Institute on Investment Company Reporting Modernization (Aug. 12, 2015) (File No. S7-08-15), *available at* http://www.sec.gov/comments/s7-08-15/s70815-315.pdf, at 7, 21-22, 41-42, 46-47; Comment Letter of Vanguard on Investment Company Reporting Modernization (Aug. 11, 2015) (File No. S7-08-15), *available at* http://www.sec.gov/comments/s7-09-15/s70915-28.pdf, at 3 (recommending that the Commission omit risk metrics from Form N-PORT, and, instead, use the raw data reported in Form N-PORT to perform its own calculation of risk metrics in order to ensure comparable results between funds); BlackRock Modernization Comment Letter, at 3.

500 *See supra* section III.D.; *see also* proposed rule 18f-4(a)(3).

metrics to only those funds who are engaged in more than a limited amount of derivatives transactions or that use certain complex derivatives transactions, as opposed to funds that engage in a more limited use of derivatives. Second, based on staff experience regarding portfolio management practices and outreach to service providers that calculate risk metrics we believe many of the funds that would be required to implement a derivatives risk management and that invest in derivatives as part of their investment strategy currently calculate risk metrics for their own internal risk management programs, or have risk metrics calculated for them by a service provider, albeit, for internal reporting purposes.

### 2. *Amendments to Proposed Form N-PORT*

Part C of proposed Form N-PORT would require a fund and its consolidated subsidiaries to disclose its schedule of investments and certain information about the fund's portfolio of investments. We propose to add Item C.11.c.viii to Part C of proposed Form N-PORT, which would require funds that are required to implement a formalized risk management program under proposed rule 18f-4(a)(3) to provide the gamma and vega for options and warrants, including options on a derivative, such as swaptions.[501]

As discussed above, gamma measures the sensitivity of delta[502] in response to price changes in the underlying instrument. Thus, gamma, in concert with delta, facilitates sensitivity analysis, which would provide the Commission and others with a more precise estimate of the effect of underlying price changes on a fund's investments, particularly for large price movements in the underlying reference asset.

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501 Item C.11.c.viii of proposed Form N-PORT.

502 Item C.11.c.vii of proposed Form N-PORT.

Vega, which measures the amount that an option contract's price changes in relation to a one percent change in the volatility of an underlying asset, would assist the Commission and others with measuring an investment's volatility. This would permit the Commission and others to, among other things, estimate changes in a portfolio based on changes in market volatility, as opposed to changes in asset prices. Vega would accordingly give the Commission and others the tools necessary to construct more comprehensive risk analyses as appropriate.

We anticipate that the enhanced reporting proposed in these amendments would help our staff better monitor price and volatility trends and various funds' risk profiles. Risk metrics data reported on Form N-PORT that is made publicly available also would inform investors and assist users in assessing funds' relative price and volatility risks and the overall price and volatility risks of the fund industry – particularly for those funds that use investments in derivatives as an important part of their trading strategy. For example, third-party data analyzers could use the reported information to produce useful metrics for investors about the relative price and volatility risks of different funds with similar strategies. Moreover, gamma, vega, and delta would help the Commission, investors, and others determine the source of a fund's risk and return.
We recognize that determining certain of the inputs that go into computing gamma and vega inherently involve some level of judgment and that some commenters expressed concern that this type of information could be confusing to investors.[503] Nevertheless, for the reasons discussed above, we believe that the reporting of gamma and vega would provide valuable information to us and market participants about current fund expectations regarding their use of certain derivatives and better understand the risks that the fund faces as asset prices and volatility change.

[503] *See supra* note 499 and accompanying text.

### 3. *Amendments to Proposed Form N-CEN*

As discussed above, proposed rule 18f-4 would require funds that engage in derivatives transactions to comply with one of two alternative portfolio limitations: the exposure-based portfolio limit under proposed rule 18f-4(a)(1)(i) or the risk-based portfolio limit under proposed rule 18f-4(a)(1)(ii).[504] We are proposing to amend Item 31 of Part C of proposed Form N-CEN to require a fund to identify the portfolio limitation on which the fund relied during the reporting period.[505] This information would allow the Commission to identify funds that rely on the exemptions under proposed rule 18f-4.

### 4. *Request for Comment*

We seek comment on each of the Commission's proposed amendments to proposed Form N-PORT and proposed Form N-CEN.[506]

- How, if at all, should we modify the scope of the proposed requirements to report gamma or vega? For example, as we discussed above, in the Investment Company Modernization Release, we requested comment on whether we should require all funds to report gamma and vega. Our current proposal would limit the reporting of gamma and vega to funds that are required to implement a derivatives risk management program. Is this appropriate, or should we require all funds that invest in derivatives with optionality to report these metrics? Alternatively, should we require reporting of these risk metrics for funds with a higher or lower exposure than 50%? Additionally, should we require

504 *See supra* Section III.B.

505 Items 31(k) and 31(l) of Proposed Form N-CEN. If a fund relied on the exposure based portfolio limit during part of the reporting period, and the risk-based portfolio limit during part of the same reporting period, it would be required to so indicate.

506 Comments regarding the proposed amendments to Forms N-PORT and N-CEN should be submitted to the comment file for this Release.

funds that are required to have a risk management program by virtue of the complexity of the derivatives they invest in, as proposed, to report such metrics, even if their exposure falls below 50%?

- We are also proposing to limit the reporting of gamma and vega to options and warrants, including options on a derivative, such as swaptions. Are there other investment products for which we should require disclosure of gamma and vega? If so, which products and why? For example, should we require funds to report gamma and vega for convertible bonds? To what extent would the inputs and assumptions underlying the methodology by which funds calculate gamma and vega affect the values reported? Are there potential liability or other concerns associated with the reporting of such measures according to such inputs and assumptions? For example, how would the comparability of information reported between funds be affected if funds used different inputs and assumptions in their methodologies?
- Are there additional or alternative metrics that we should consider requiring to be reported? Would the disclosure of risk metrics such as theta – the change in value of an option with changes in time to expiration – enhance the utility of the derivatives information reported in Form N-PORT? What would be the costs and burdens to funds and benefits to investors and other potential users of requiring funds to report such additional or alternative metrics? How would the comparability of information reported by different funds be affected if funds used different inputs and assumptions in their methodologies, such as different assumptions regarding the values of the funds' portfolios?

- We believe that funds that would be required to implement a derivatives risk management program already track certain derivative risk metrics, such as gamma and vega. Is our assumption correct? To the extent this is correct, what would be the incremental cost and burden of reporting such information to the Commission? As discussed above, in the Investment Company Reporting Modernization Release, we proposed that portfolio-level risk metrics and the delta for relevant investments be disclosed on each report on Form N-PORT that is made public (*i.e.*, quarterly). Likewise, we are proposing that gamma and vega be made publicly available. Should gamma and vega be made public? Are the factors that the Commission should consider when determining whether to make such measures public the same as for the other risk metrics proposed in the Investment Company Modernization Release, or are there additional factors relevant to gamma and vega that we should consider?
- As discussed above, proposed rule 18f-4 would require funds that engage in derivatives transactions to comply with one of two alternative portfolio limitations: the exposure-based portfolio limit or the risk-based portfolio limit. While we are proposing to require that funds maintain certain records relating to their compliance with the applicable portfolio limitation, we are not proposing that they report to the public or the Commission the funds' aggregate exposure or, for funds that operate under the risk-based portfolio limit, the results of the funds' VaR tests. Would there be a benefit to publicly reporting this information? Should we require funds to report on proposed Form N-CEN or Form N-PORT either or both of the funds' aggregate exposures or their securities' VaRs and full portfolio VaRs (if applicable)? Additionally, as proposed, the derivative risk management program would apply to funds with an aggregate exposure to

derivatives transactions that exceeds 50% of net assets. Should funds be required to report on proposed Form N-CEN or Form N-PORT their aggregate exposure to derivatives transactions?

- Form N-PORT also requires funds to report their notional amounts for certain derivatives transactions. Should we define "notional amount" for purposes of Form N-PORT with the same definition as proposed by rule 18f-4?
- Our proposal would require funds to identify in reports on Form N-CEN whether they relied upon the proposed rule by identifying the portfolio limitation(s) on which the fund relied during the reporting period. Do commenters agree that this is appropriate? Should we instead require a fund to only identify if it relied upon rule 18f-4 during the reporting period, rather than requiring the fund to identify the specific portfolio limitation(s) on which the fund relied? Are there other mediums, such as the Statement of Additional Information, that would be more appropriate to report such information?
- Should we provide a compliance period for the proposed amendments to Forms N-PORT and N-CEN? If so, what factors should we consider, if any, when setting the compliance dates for the proposed amendments to Forms N-PORT and N-CEN? How long of a compliance period would be appropriate for the proposed amendments? If we provide a compliance period for the proposed amendments, should we provide a tiered compliance date for entities based on their size?

### H. Request for Comments

We request and encourage any interested person to submit comments regarding the proposed rule and the proposed amendments to Form N-PORT and Form N-CEN, specific issues discussed in this Release, and other matters that may have an effect on the proposed rule and the proposed changes to Form N-PORT and Form N-CEN. With regard to any comments, we note that such comments are of particular assistance to our rulemaking initiative if accompanied by supporting data and analysis of the issues addressed in those comments.

### I. Proposed Rule 18f-4 and Existing Guidance

If we adopt proposed rule 18f-4, we would rescind Release 10666 and our staff's no-action letters addressing derivatives and financial commitment transactions. Funds would only be permitted to enter into derivatives transactions and financial commitment transactions to the extent permitted by, and consistent with the requirements of, rule 18f-4 or section 18 or 61. At this time, however, we are not rescinding Release 10666 or any no-action letters issued by our staff, and funds may continue to rely on Release 10666, our staff no-action letters, and other guidance from our staff.

A fund would be able to rely on the rule after its effective date as soon as the fund could comply with the rule's conditions. We would, in addition, expect to provide a transition period during which we would permit funds to continue to rely on Release 10666, our staff no-action letters, and other guidance from our staff, including with respect to derivatives transactions and financial commitment transactions entered into by a fund after the rule's effective date but before the end of any transition period.

We request comment on any transition period:

- Do commenters agree that a transition period would be appropriate?
- What would be an appropriate amount of time for us to provide before rescinding Release 10666 and our staff's no-action letters?
- In recently proposed rule 22e-4, we proposed tiered compliance dates for funds that would be required to establish liquidity risk management programs under that rule, generally proposing to provide a compliance period of 18 months for

larger entities and an extra 12 (or 30 total months) for smaller entities.[507] Would these time periods provide sufficient time for funds to transition to proposed rule 18f-4? Would they provide more time than may be necessary or appropriate?

- Would it be appropriate, for purposes of a transition period (rather than setting a compliance date), to provide different periods of time for larger and smaller entities? Would it be appropriate to instead require all funds that engage or seek to engage in derivatives or financial commitment transactions to do so in reliance on proposed rule 18f-4 after a period of time that would be the same for all affected funds, for example 18 months after any adoption of proposed rule 18f-4?
- Should we provide a longer transition period for particular types of funds? If so, which kinds of funds and how much time should we provide? Should we, for example, provide a longer transition period for leveraged ETFs on the basis that they operate pursuant to the terms and conditions of exemptive orders granted by the Commission? In section III.B.1.c, we requested comment as to whether it would be more appropriate to consider these funds' use of derivatives transactions in the exemptive application context, based on the funds' particular facts and circumstances, rather than in rule 18f-4. If commenters believe this would be appropriate, would a longer transition period for these funds also be

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507 *See* Liquidity Release, *supra* note 5 (generally categorizing funds that together with other investment companies in the same "group of related investment companies" have net assets of $1 billion or more as of the end of the most recent fiscal year as larger entities and funds that together with other investment companies in the same "group of related investment companies" have net assets of less than $1 billion as of the end of the most recent fiscal year as smaller entities).

appropriate in order to provide time for these funds to prepare, and for the Commission to consider, any exemptive applications?

## IV. Economic Analysis

### A. Introduction and Primary Goals of Proposed Regulation

The Commission is sensitive to the economic effects that could result from proposed rule 18f-4 and the proposed amendments to proposed Forms N-PORT and N-CEN. The economic effects of proposed rule 18f-4 include the benefits and costs of the proposed rule, as well as effects on efficiency, competition, and capital formation. The economic effects of the proposed rule are discussed below in the context of the primary goals of the proposed regulation. We discuss the benefits, costs, and economic effects associated with our proposed amendments to proposed Forms N-PORT and N-CEN in sections IV.D.6 and IV.D.7, below.

In summary, and as discussed in greater detail throughout this Release, the proposed rule would require a fund that enters into derivatives transactions in reliance on the rule to:

- Comply with one of two alternative portfolio limitations designed to impose a limit on the amount of leverage the fund may obtain through derivatives transactions and other senior securities transactions;[508]
- Manage the risks associated with its derivatives transactions by maintaining qualifying coverage assets in an amount designed to enable the fund to meet its obligations under its derivatives transactions; and
- Establish a formalized derivatives risk management program (unless otherwise exempt

508 As discussed above, the proposed rule would limit indebtedness leverage created through derivatives transactions that involve the issuance of senior securities (*i.e.*, because these transactions involve a payment obligation). The proposed rule would not limit economic leverage created through derivatives (*e.g.*, purchased options) that would generally not be considered to involve the issuance of senior securities (*i.e.*, because these transactions do not involve a payment obligation).

based on the extent of its derivatives usage).

The proposed rule would also require a fund that enters into financial commitment transactions in reliance on the rule to maintain qualifying coverage assets equal in value to the fund's full obligations under those transactions.

As discussed above in section II.D.1.a, we have determined to propose a new approach to funds' use of derivatives in order to address the investor protection purposes and concerns underlying section 18 of the Act and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions. The investor protection purposes and concerns include the concern that leveraging an investment company's portfolio through the issuance of senior securities magnifies the potential for gain or loss and therefore results in an increase in the speculative character of the investment company's outstanding securities. In Release 10666, we permitted funds to engage in the transactions described in that release using the segregated account approach, notwithstanding the limitations in section 18, because we believed that the segregated account approach would address the investor protection purposes and concerns underlying section 18 by imposing a practical limit on the amount of leverage a fund may undertake and assuring the availability of adequate assets to meet the fund's obligations arising from such transactions.

As we discussed above, the current regulatory framework, including application of the segregated account approach enunciated in Release 10666 to derivatives transactions, has developed over the years since we issued Release 10666 as funds and our staff sought to apply our statements in Release 10666 to various types of derivatives and other transactions on an instrument-by-instrument basis. One significant result of this process has been funds' expanded use of the mark-to-market segregation approach with respect to various types of derivatives, together with the segregation of a variety of liquid assets. Funds' use of the mark-to-market segregation approach with respect to various types of derivatives, plus the segregation of any liquid asset, enables funds to obtain leverage in amounts that may not be consistent with the concerns underlying section 18 of the Act. As we noted above, segregating only a fund's daily mark-to-market liability—and using any liquid asset—enables the fund, using derivatives, to obtain exposures substantially in excess of the fund's net assets. In addition, a fund's segregation of any asset that the fund deems sufficiently liquid to cover a derivative's daily mark-to-market liability may not effectively result in the fund having sufficient liquid assets to meet its future obligations under the derivative.

The proposed rule is designed to address the investor protection purposes and concerns underlying section 18 and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions in light of the dramatic growth in the volume and complexity of the derivatives markets over the past two decades and the increased use of derivatives by certain funds. Under the proposed rule, funds would be permitted to enter into derivatives transactions and financial commitment transactions in reliance on the rule, subject to its conditions.

The proposed rule provides both for an outside limit on the magnitude of funds' derivatives exposures designed primarily to address concerns about excessive leverage and undue speculation and a requirement to manage risks associated with its derivatives transactions by maintaining qualifying coverage assets that is designed primarily to address concerns about a fund's ability to meet its obligations in connection with its derivatives and financial commitment transactions. The proposed rule also seeks to provide a balanced and flexible approach by permitting funds to obtain additional derivatives exposure (under the risk-based portfolio limit) where the fund's derivatives, in the aggregate, have a risk-mitigating effect on the fund's overall portfolio.

As noted above, the proposed rule includes asset segregation requirements for both derivatives transactions and financial commitment transactions. With regard to derivatives, a fund would be required to assess both the current and future payment obligations (and therefore, potential losses) arising from its derivatives transactions. With regard to financial commitment transactions, a fund would be required to maintain qualifying coverage assets equal in value to the fund's full obligations under those transactions.

Finally, except for funds that engage in only a limited amount of derivatives transactions and that do not use certain complex derivatives transactions, the fund would be required to establish a derivatives risk management program, including the appointment of a derivatives risk manager. The derivatives risk management program requirement is designed to complement the portfolio limitations and asset coverage requirements by requiring a fund subject to the requirement to assess and manage the particular risks presented by the fund's use of derivatives.

**B. Economic Baseline**

The proposed rule would affect funds and their investors, investment advisers, and market participants engaged in the issuance, trading, and servicing of derivatives, financial commitment transactions, and securities. Market participants include fund counterparties and other third-party service providers such as fund custodians and administrators.[509] The effects on

[509] Throughout the economic analysis we discuss the potential effects of the proposed rule and estimate the costs to funds to perform the enumerated types of activities that we anticipate would be required to comply with the proposed rule's specific requirement(s). We note that these costs may be incurred, in whole, or in part, by a fund, its investment adviser, or one of its service providers (*e.g.*, fund custodian, or fund administrator). Except where addressed specifically below, we do not, however, have information available to us to reasonably estimate how the costs for such activities may be allocated among these parties.

all of these parties are discussed below in the discussion of the costs and benefits of the proposed rule.

The economic baseline of the proposed rule is the current industry practice established in light of Commission and staff positions that funds rely upon when determining whether they are permitted under the Act to engage in derivatives transactions and financial commitment transactions. As discussed above in section II.B.3, funds that engage in these types of transactions typically segregate "liquid" assets using one of two general practices: notional amount segregation or mark-to-market segregation. The current approach has developed over the years since we issued Release 10666 as funds and our staff sought to apply our statements in Release 10666 to various types of derivatives and other transactions. We understand that, in determining how they will comply with section 18, funds consider various no-action letters issued by our staff. These staff letters, issued primarily in the 1970s through 1990s, addressed particular questions presented to the staff concerning the application of the approach enunciated in Release 10666 to various types of derivatives on an instrument-by-instrument basis. We understand that funds also consider, in addition to these letters, other guidance they may have received from our staff and the practices that other funds disclose in their registration statements. The current approach's development on an instrument-by-instrument basis, together with the dramatic growth in the volume and complexity of the derivatives markets over the past two decades, has resulted in situations for which there is no specific guidance from us or our staff with respect to various types of derivatives.

Our staff economists have analyzed recent industry-wide trends and certain funds' portfolio holdings in order to provide information about funds' use of derivatives and to inform our consideration of the proposed rule and assess its economic effects.[510] Below we discuss the size and recent growth of the U.S. fund industry generally, as well as the growth of specific fund types within the industry. As discussed below, the fund industry has grown significantly since 2010 and certain funds that make greater use of derivatives have received a disproportionately large share of fund inflows. This information highlights the importance of a new approach to regulating derivatives transactions under section 18 and, together with the information we discuss below concerning the extent to which certain funds use derivatives, has helped to shape the scope and substance of the proposed rule, as well as identify the benefits, costs, and effects on efficiency, competition, and capital formation.

According to Morningstar, at the end of June 2015, there were 9,707 registered open-end funds, 560 closed-end funds, and 1,706 ETFs (11,973 total funds) with a total reported AUM of $17.9 trillion.[511] Of that total, open-end funds held $15.9 trillion, closed-end funds held $250 billion, and ETFs held $1.8 trillion. In terms of fund categories, 3,361 US equity funds held the largest percentage (38%) of industry AUM, followed by 2,073 taxable bond funds (19%), 1,914 allocation funds (17%), and 1,877 international equity funds (15%). As of June 2015, there were

510 This analysis is included in the DERA White Paper, *supra* note 73. *See* text surrounding *supra* note 87.

511 DERA White Paper, *supra* note 73, Table 1. These figures do not include money market funds or BDCs. Under rule 2a-7 of the Act, money market funds are required to limit their investments to short-term, high-quality debt securities that fluctuate very little in value under normal market conditions. Money market funds thus do not engage in derivatives transactions, but may enter into certain financial commitment transactions to the extent permitted by rule 2a-7. *See supra* note 472. Similarly, BDCs, based on the DERA sample, do not appear to enter into derivatives transactions to a material extent (no sampled BDC reported any derivatives transactions in its then-most recent annual report). BDCs do, however, appear to enter into financial commitment transactions as defined in the proposed rule based on the DERA sample. We provide aggregate figures for money market funds and BDCs separately. *See infra* note 578.

537 money market funds with an estimated $3.0 trillion in AUM.[512] In addition, based on Commission records (Form 10-Ks and 10-Q's), at the end of June 2015, there were 88 active business development companies ("BDCs") with an estimated $52.3 billion in AUM.

Although not large in terms of industry AUM (less than 3% as of June 2015[513]), the growth in AUM of alternative strategy funds, which tend to be greater users of derivatives, is notable. In 2010, there were a total of 591 alternative strategy funds with a total AUM of $320 billion.[514] By the end of 2014 those numbers had risen to 1,125 funds with a total AUM of $469 billion. The annual growth rate in the AUM of alternative strategy funds from the end of 2010 through the end of 2014 was 10%.[515] Excluding commodity funds (which had a negative growth rate during this period), alternative strategy funds had an annual growth rate of 22%. During this four-year period, alternative strategy funds received the largest net inflows (14% annually) relative to their total asset base. Excluding commodity funds, alternative strategy funds had an annual net inflow of 28%.[516] Over the four-year period since 2010, alternative strategy funds also received a disproportionate share of net fund flows. These funds received 10% of all industry net inflows while comprising only 3% of industry AUM as of 2010. Excluding commodity funds, alternative strategy funds received 11% of all industry net inflows while comprising only 1.6%

512 Data taken from reports filed on Form N-MFP for June 2015.

513 DERA White Paper, *supra* note 73, Table 1. We refer to alternative strategy funds in the same manner as the staff classified "Alt Strategies" funds in the DERA White Paper as including the Morningstar categories of "alternative," "nontraditional bond" and "commodity" funds.

514 DERA White Paper, *supra* note 73, Table 2.

515 During the 2010 – 2014 time period, the annual growth rate of US equity funds was 14%, the sector equity funds growth rate was 18%, the international equity fund growth rate was 9%, the allocation fund growth rate was 16%, the taxable bond fund growth rate was 10%, and the municipal bond fund growth rate was 6%.

516 During the 2010 – 2014 time period, annual net flows as a percent of fund AUM were 0% for US equity funds, 10% for sector equity funds, 6% for international equity funds, 7% for allocation funds, 7% for taxable bond funds, 1% for municipal bond funds, and -2% for commodity funds.

of industry AUM as of 2010.

DERA staff manually collected data regarding derivatives, financial commitment transactions, and other senior security transactions from the then-latest fund annual reports of a 10% random sample of all registered management investment companies as well as business development companies as of June, 2015.[517] As discussed above, we recognize that the review by DERA staff evaluated funds' investments as reported in the funds' then-most recent annual reports. DERA staff, however, is not aware of any information that would provide any different data analysis of the current use of senior securities transactions by registered funds and business development companies. DERA staff prepared an analysis of each sampled fund's aggregate exposure by aggregating, for each fund: (i) the notional amounts of the fund's derivatives transactions, as defined in the proposed rule; (ii) the financial commitment obligations associated with the fund's financial commitment transactions, as defined in the proposed rule; and (iii) the indebtedness associated with any other senior securities transactions.[518]

In the resulting sample of 1,188 funds, 68% (53% in AUM) had zero exposure to derivatives and approximately 89% (90% in AUM) had less than 50% exposure as a percentage

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517 DERA staff included in its sample open-end funds (including ETFs), closed-end funds, and BDCs, but excluded money market funds (because these funds do not invest in derivatives transactions). For the alternative strategy funds, DERA staff required in its sample a minimum of three funds selected from each Morningstar subcategory. Morningstar subcategories include, among others, managed futures, multicurrency, bear market, multialternative, market neutral, long/short equity, trading inverse and trading leveraged.

518 The aggregate notional amount for derivatives in the DERA random sample is approximately $350 billion. The Bank for International Settlements reports that the aggregate notional amount for derivatives worldwide at the end of 2014 was approximately $688 trillion ($58 trillion exchange traded and $630 trillion over-the-counter). *See* http://www.bis.org/statistics/about_derivatives_stats.htm?m=6|32. BIS data on exchange-traded derivatives is collected from over 50 organized exchanges and includes information on interest rate and foreign exchange derivatives only. BIS data on OTC derivatives is from large dealers in 13 countries and includes forwards, swaps, and options on foreign exchange, interest rates, and equities.

of NAV.[519] Approximately 96% (95% in AUM) of the funds had aggregate exposures below 150%.[520] As a result, we expect that a majority of funds would not be required to modify their portfolios in order to comply with the proposed rule because a substantial majority of funds do not appear (based on the DERA sample) to engage in derivatives transactions or financial commitment transactions and thus may not need to rely on the exemption the proposed rule would provide, or do not appear to engage in those transactions at a level that would exceed the proposed rule's exposure limitations.[521] Funds that do engage in derivatives transactions and financial commitment transactions would, however, need to rely on the proposed rule to continue to engage in these transactions.

DERA examined the detailed holdings for every fund in its sample and found that alternative strategy funds hold the most derivatives and have the highest exposure (expressed as aggregate notional amounts relative to fund net asset value). Among alternative strategy funds, 73% had at least some exposure to derivatives and 52% had greater than 50% exposure to derivatives.[522] For traditional mutual funds, 29% had at least some exposure to derivatives and 6% had greater than 50% exposure to derivatives. Not only did alternative strategy funds have greater derivatives exposures, but their holdings also were larger (as measured in terms of notional amount relative to fund net asset value). For alternative strategy funds with derivatives,

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519 DERA White Paper, *supra* note 73, Figures 11.1, 12.1.

520 DERA White Paper, *supra* note 73, Figures 9.1, 10.1.

521 *See supra* note 212 and accompanying text. We recognize that some of the funds in DERA's sample that had no exposure to derivatives or financial commitment transactions in their then-most recent annual reports also may engage in these transactions to some extent. As discussed above, DERA staff is not aware of any information that would provide any different data analysis of the current use of senior securities transactions by registered funds and business development companies.

522 DERA White Paper, *supra* note 73, Figure 11.4.

mean and median notional values of derivatives were 167% and 99% of net assets, respectively.[523] As a point of comparison, for traditional mutual funds, the comparable numbers were 36% and 10%, respectively. Approximately 27% of alternative strategy funds had 150% or greater aggregate exposure, compared to less than 2% for traditional mutual funds.[524]

As noted above, as of June 2015, there were 560 closed-end funds with total AUM of $250 billion. In DERA's random sample of the funds, 47% of closed-end funds had some exposure to derivatives.[525] Nine percent of closed-end funds had at least a 50% exposure to derivatives. No closed-end fund had aggregate exposure over 150% of net assets.[526]

Also as noted above, as of June 2015, there were 1,706 ETFs and 88 BDCs with total AUM of $1.8 trillion and $52.3 billion, respectively. In DERA's random sample of the funds, 29% of ETFs and zero BDCs had some exposure to derivatives.[527] Eighteen percent of ETFs had exposure to derivatives of 50% or more (86% among alternative strategy ETFs). Eight percent of ETFs had aggregate exposure over 150% of net assets.[528]

Our staff also analyzed, through a review of recent N-SAR filings, the extent to which funds are permitted (as stated in fund disclosure documents) to use certain derivatives as part of their investment objective or strategy.[529] In each case, more alternative funds[530] were authorized

523 DERA White Paper, *supra* note 73, Table 6, Panel D.

524 DERA White Paper, *supra* note 73, Figures 9.4, 9.5.

525 DERA White Paper, *supra* note 73, Figure 11.7.

526 DERA White Paper, *supra* note 73, Figure 9.7.

527 DERA White Paper, *supra* note 73, Figures 11.10, 11.11.

528 DERA White Paper, *supra* note 73, Figure 9.10.

529 DERA White Paper, *supra* note 73. This portion of the DERA analysis used a sample consisting of all funds filing form N-SAR for 2014 (12,360 in total). Form N-SAR, filed with the Commission and made publicly available, is filed semi-annually by all registered investment companies and provides census-type data about the registrant (recently, the Commission proposed new rules that would rescind Form N-SAR and replace it with a more modernized and updated

to invest in derivatives than other funds.[531] For example, the number of alternative funds permitted to invest in options on equities, options on stock indices, stock index futures, and options on index futures was 20% greater than the number of traditional mutual funds.[532] Although not all of these instruments would be deemed a "derivatives transaction" under the proposed rule (*e.g.*, a purchased option), information about the extent to which funds are permitted to invest in these instruments may provide an indication of the extent to which funds engage in strategies that would involve the use of derivatives transactions subject to the proposed rule.

Under the current regulatory framework, funds that invest in derivatives and other senior securities generally segregate certain assets with respect to those transactions. While our staff has observed that some funds have interpreted the guidance differently in certain cases, we assume for purposes of establishing the baseline that funds generally segregate sufficient assets to cover at least any mark-to-market liabilities on the funds' derivatives transactions, with some funds segregating more assets for certain types of derivatives and transactions (sufficient to cover the full notional amount of the transaction or an amount in between the transaction's full notional amount and any mark-to-market liability).

There is currently no requirement for funds that invest in derivatives to have a risk

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census form, proposed Form N-CEN). *See* Investment Company Reporting Modernization Release, *supra* note 138. Form N-SAR requires funds to answer questions with respect to whether they are allowed to invest in the following derivatives: options on equities, options on debt securities, options on stock indices, interest rate futures, stock index futures, options on futures, options on index futures, and other commodity futures.

530 Morningstar U.S. category "Alternative funds."

531 DERA White Paper, *supra* note 73, Table 3, Panel A.

532 DERA White Paper, *supra* note 73, Table 3, Panel A. The comparable differences for options on debt securities, interest rates futures, options on futures, and other commodity options are 8%, 12%, 16%, and 21%, respectively.

management program with respect to their derivatives transactions, although we understand that the advisers to many funds whose investment strategies could entail derivatives already assess and manage the risks associated with derivatives transactions. Funds' current risk management practices may not meet the proposed rule's specific risk-management program requirements, however, and therefore we believe that the baseline for the derivatives risk management program requirement would be that all funds that would be subject to the requirement would need to establish such a program or conform their current practices to satisfy the requirements in the proposed rule.

### C. Economic Impacts, Including Effects on Efficiency, Competition, and Capital Formation

Below, we discuss anticipated economic impacts, including effects on efficiency, competition, and capital formation that may result from our proposals. Where possible, we have attempted to quantify the costs, benefits, and effects of the proposed rule and amendments to Forms N-PORT and N-CEN. In many cases, however, we are unable to quantify the economic effects because we lack the information necessary to provide a reasonable estimate.

As discussed above, there is substantial diversity in the types and strategies of funds and how and to what extent funds use derivatives. Moreover, for those funds that do use derivatives, there is substantial variability in how they comply with current Commission positions and staff guidance on compliance with section 18 (including asset segregation). There is also substantial variability in how any given fund may react to the proposed rule, if adopted, and how the market may react in turn. A fund that uses a moderate amount of derivatives may increase or decrease its derivative usage, or shift within types of derivatives (*e.g.*, from cash-settled to physically-settled). A fund may alter its investment strategy in order to comply with one of the proposed rule's portfolio exposure limitations by reducing use of derivatives and not substituting other instruments to achieve equivalent exposures. To the extent that a fund alters its investment strategy, this change may represent an opportunity cost to investors. Such opportunity costs depend on investors' individual preferences and are, as a result, difficult to quantify. Alternatively, a fund may shift the composition of its portfolio away from derivatives covered by the proposed rule, either by using derivatives not covered by the proposed rule, or by substituting the purchase of derivatives with a purchase of the underlying assets (or similar assets). Such a shift in portfolio composition would involve transactions costs. Those transactions costs would depend on both the amount of the portfolio to be traded, as well as the liquidity of the assets to be traded, both of which are likely to vary widely from fund to fund (and thus are difficult to quantify). Finally, a fund may seek to operate in a structure not subject to the limitations of section 18.[533] We discuss these potential economic impacts in more detail below. Although much of the following discussion is qualitative in nature, we have sought to quantify certain costs, benefits, and effects of the proposed rule, where possible.[534]

We believe that the proposed rule is likely to strengthen investor protection. First, the proposed rule would limit the amount of leverage that a fund may obtain through derivatives transactions and other senior securities transactions. Under the proposed rule, a fund that seeks to comply with the exposure-based portfolio limit would be required to limit its aggregate exposure to 150% of the fund's net assets, and a fund that seeks to comply with the risk-based

533 We quantify estimated costs related to a fund that chooses to deregister under the Investment Company Act and liquidate and/or offer the fund's strategy as a private fund or commodity pool. *See infra* note 554 and accompanying text.

534 We discuss below in section IV.D, other potential benefits and quantified costs that we anticipate may result from certain core aspects of the proposed rule, including the exposure-based and risk-based portfolio limitations, the asset segregation requirements, the derivatives risk management program, requirements for financial commitment transactions, and amendments to proposed Forms N-PORT and N-CEN.

portfolio limit would be required to demonstrate, through a value-at-risk-based test,[535] that its use of derivatives reduces the fund's exposure to market risk, and limit its aggregate exposure to 300% of the fund's net assets. The proposed aggregate exposure limitations are likely to reduce, but not eliminate, the risk that investors will experience losses associated with leveraged investment exposures that significantly exceed a fund's net assets. Second, the proposed rule would require that a fund manage risks associated with its derivatives transactions by maintaining an amount of certain assets, defined in the proposed rule as "qualifying coverage assets," designed to enable the fund to meet its obligations under its derivatives transactions (and financial commitment transactions). We expect that, to the extent the proposed rule strengthens investor protection, the proposed rule should also both sustain and promote investors' willingness to participate in the market. This could lead to increased investment in funds, which in turn could lead to increased demand for securities which could, in turn, promote capital formation.

As we have discussed above, leverage magnifies losses that may result from adverse market movements. As a result, a fund that obtains leverage through derivatives and other senior securities transactions may suffer those magnified losses and, because losses on a fund's derivatives transactions can create payment obligations for the fund, the losses can force a fund's adviser to sell the fund's investments to generate liquid assets in order for the fund to meet its obligations. This could force the fund to enter into forced sales in stressed market conditions,

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[535] The proposed rule would require that a fund seeking to comply with the risk-based portfolio limit satisfy the VaR test included in that portfolio limit, that is, limit its use of derivatives transactions so that, immediately after entering into any senior securities transaction, the fund's "full portfolio VaR" is less than the fund's "securities VaR," as those terms are defined in the proposed rule. A fund would also be required to limit its aggregate exposure to 300% of the fund's net assets.

resulting in large losses or even liquidation.[536] The proposed rule, by effectively imposing a limit on the amount of leverage a fund may obtain through derivatives, should reduce the possibility of fund losses attributable to leverage. This can have investor protection benefits as well as reduce the risk of adverse effects on fund counterparties. More robust asset segregation requirements also may have the effect of increasing a fund's liquidity, decreasing default risk, and decreasing the risk that a fund may be forced to sell securities in a falling market to meet its obligations under its derivatives transactions (*e.g.*, to meet margin calls). For these reasons, we believe that the proposed rule should encourage capital formation by promoting investors' willingness to invest in funds (or to remain invested in them even in a falling market) and market stability.

The proposed rule may reduce costs and promote efficiency with respect to certain uses of derivatives by replacing the current regulatory framework that depends upon interpretation of Commission and staff guidance with a more transparent and comprehensive regulatory framework that addresses more effectively the purposes underlying section 18. The proposed rule would eliminate disparities under the current regulatory framework, where funds segregate the full notional amount for certain derivatives and segregate only the mark-to-market liability for other types of derivatives. For example, current staff guidance generally calls for a fund to

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536 *See* Thurner, Farmer & Geanakoplos, *Leverage Causes Fat Tails and Clustered Volatility* (May 2012) (discussing investments collateralized by margin and noting that "[t]he nature of the collateralized loan contract thus sometimes turns buyers of the collateral into sellers, even when they might think it is the best time to buy. . . . When the funds are unleveraged, they will always buy into a falling market, i.e. when the price is dropping they are guaranteed to be buyers, thus damping price movements away from the fundamental value. When they are sufficiently leveraged, however, this situation is reversed they sell into a falling market, thus amplifying the deviation of price movements away from fundamental value."). *See also* Off-Balance-Sheet Leverage IMF Working Paper, *supra* note 79 ("[A] more leveraged investor facing a given adverse price movement may be forced by collateral requirements (i.e. margin calls) to unwind the position sooner than if the position were not leveraged. The unwinding decision of an unleveraged investor depends merely on the investor's risk preferences and not on potentially more restrictive margin requirements.").

segregate liquid assets equal in value to the full notional amount of a physically settled futures contract. A fund that wishes to avoid encumbering a large portion of its liquid assets might be incentivized to instead enter into a cash settled OTC swap on the same futures contract and segregate only its mark-to-market liability (if any) under the swap, even if the swap entails higher transaction costs, is less liquid, and/or poses greater counterparty risk. The risk may be compounded further because the mark-to-market segregation approach potentially enables the fund to obtain a level of leverage that is many times greater than its net assets. By contrast, under the proposed rule's portfolio limitations, a physically settled futures contract and a cash-settled swap on the futures contract, both of which have the same notional amount, would be subject to the same treatment. This approach should serve to reduce the likelihood that a fund would choose a less efficient instrument to obtain its investment exposures and also reduce the uncertainty that exists regarding treatment of new products that are not addressed specifically in existing Commission or staff guidance. By providing consistency in how funds treat different derivatives transactions, we believe that the proposed rule should reduce opportunities for regulatory arbitrage where a fund prefers "cheap-to-cover" derivatives—those for which a fund applies the mark-to-market segregation approach—and therefore promote a more efficient use of derivatives instruments by funds when implementing their portfolio strategies.

As discussed above in section III.C.1, the proposed rule would require that a fund maintain qualifying coverage assets, for each derivatives transaction, in an amount equal to the sum of (1) the amount that would be payable by the fund if the fund were to exit the derivatives transaction at the time of the determination (the "mark-to-market coverage amount"), and (2) an amount that represents an estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions (the "risk-based coverage amount").

The proposed rule is designed to be flexible enough to allow a fund to determine these amounts both for existing types of derivatives transactions and for new derivatives instruments that are created in the future. For example, the proposed rule provides that a derivatives transaction's risk-based coverage amount would be an amount that represents an estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions, determined in accordance with policies and procedures that address certain considerations specified in the rule. The proposed rule thus does not prescribe the particular methodology that a fund must use to calculate its risk-based coverage amount when segregating assets on its derivatives transactions. Instead, the proposed rule permits a fund to make such determinations in accordance with policies and procedures approved by the fund's board, based on a fund's particular facts and circumstances. We believe that this flexible approach would permit, and may promote, appropriate innovation in the development and use of new derivative instruments that may be beneficial for funds and investors. We also believe that this may increase investor protection by requiring that funds assess the risk of their derivatives transactions and segregate assets to cover an amount in addition to the mark-to-market liability.

Many of the impacts of the proposed rule will depend on how funds react to the conditions it imposes. As an initial matter, based on the DERA staff analysis, which shows that a substantial majority of funds in the DERA sample did not use derivatives or used derivatives to a limited extent, the portfolio limits under the proposed rule are not expected to affect the investment activities of a majority of funds.[537] Funds that react to the rule, however, may do so in several different ways.

Some funds will not be compelled by the proposed rule to modify their derivatives

[537] DERA White Paper, *supra* note 73, Table 6.

exposure, but they might nonetheless respond to the proposed rule's treatment of derivatives by modifying their derivatives holdings. For example, because funds today apply the notional amount segregation approach to certain derivatives, such as physically settled Treasury futures or CDS, there exists, as discussed above, an incentive for funds to invest in derivatives for which funds apply the mark-to-market segregation approach. Because the proposed rule would remove the disparate treatment for different derivatives with the same notional amounts, it is possible that the proposed rule may result in greater use of the types of derivatives that funds today may use less extensively because of the need to apply the notional amount segregation approach. By contrast, funds that today only segregate the mark-to-market liability for their derivatives would need to segregate a greater quantity of assets and, if the fund had not been segregating cash and cash equivalents, would generally be required to segregate assets that are more liquid. Such a fund could determine to reduce its derivatives exposure to avoid segregating a greater quantity of assets that are cash and cash equivalents. Similarly, funds that use derivatives in an amount that minimally exceeds the threshold for implementing a risk management program may reduce derivatives use below that threshold in order to avoid that cost. To the extent that any funds were hesitant to use derivatives (or any particular type of derivative) given the lack of specific Commission or staff guidance addressing certain derivatives, these funds might become more willing to use those derivatives under the proposed rule. Thus, the proposed rule may lead to an increase or decrease in the use of particular derivatives or an increase or decrease in derivatives use by particular funds.

Because we do not know to what extent the current regulatory framework for derivatives may have been influencing funds' use of derivatives — for example, the extent to which differences in the two approaches to asset segregation may have been distorting funds' choices of products in the current market — we do not know to what extent funds would change existing positions, or would enter into different positions going forward, under the proposed rule. Accordingly, we cannot quantify this potential effect. We discuss the potential effects of each directional option (decreasing derivatives use, shifting portfolio composition, or increasing derivatives use) below.

A fund may incur costs to reduce derivatives use if it pays a penalty or other amount to a counterparty to unwind a position, or if the fund sells its position to a third party (or the fund enters into a directly offsetting position to make use of the netting provision in the proposed rule.) To the extent that a fund uses derivatives for directional exposure, reducing the use of derivatives could reduce returns to the fund's shareholders. This could potentially make the fund (i) less attractive to existing shareholders who desire greater market exposure; or (ii) more attractive to new shareholders who prefer lower levels of exposure (or encourage current shareholders to increase their investment in the fund because of the lower derivatives exposure). To the extent that a fund uses derivatives for hedging, reducing derivatives use could change the risk profile of the fund's portfolio, depending on the derivative position that the fund determines to close as well as other related changes the fund determines to make to its portfolio.[538]

A fund that determines to shift the composition of derivatives used, for example toward physically-settled derivatives, would incur transaction costs in modifying the portfolio — the costs to exit prior positions and to enter into new ones. But the benefits to the fund of holding a more "optimal" (from its perspective) composition of derivatives—*i.e.*, one that is not influenced by the differential regulatory treatment of certain derivatives—could offset in whole or in part, or even exceed, those costs.

538 We discuss below potential limitations on a fund's ability to use derivatives for hedging purposes.

A fund that determines to increase its use of derivatives would incur transaction costs to enter into the new positions and, if those new positions were to cause the fund's exposure to exceed 50% of net asset value, the fund would be required to adopt and implement a formalized derivatives risk management program under the proposed rule and incur the associated costs. The impacts to the funds' investors would be different from those experienced by investors in funds that determine to reduce derivatives exposure. If the derivatives are used for directional exposure, the increase in leverage increases the potential for increased returns but also increases risk of loss, which some investors might prefer and others might not. If the derivatives are used for hedging, the increase in derivatives could increase or decrease the level of risk (and thus potential return) that the fund assumes, depending on the particular derivatives entered into.

With respect to each of the possibilities listed above, and for several additional options discussed in greater detail below, we describe the existence of transaction costs for the fund to terminate or transfer existing obligations, and to enter into new ones. These costs include fees, and operational and administrative costs, as well as the spread paid to intermediaries and the market impact on prices, if any. The degree of mark-ups and market impact can turn on the transparency and liquidity of the market, as well as the size of other market participants (*i.e.*, counterparties) and competitiveness in the market. There may also be tax costs. We lack the data to quantify these potential transaction costs. While some of the derivatives instruments are exchange-traded, many of these instruments are bilaterally negotiated. We believe costs would generally be lower for more liquid, exchange-traded derivatives when compared with more complicated, bespoke, or OTC-traded derivatives. We also believe costs would generally be lower for larger market participants that actively transact in derivatives versus smaller market participants.[539]

Some types of funds use derivatives more extensively. Alternative strategy funds, in particular, have experienced significant growth and have been shown to be heavier users of derivatives. Four managed futures funds in DERA's sample, for example, exhibited aggregate notional exposures ranging from approximately 500% to 950% of net assets, far greater than the exposure limits we are proposing today. Some ETFs (or other funds) expressly use derivatives to obtain a leveraged multiple of two or three times the daily performance (or inverse performance) of an index. Some of these funds had derivatives exposures exceeding 150% of net assets.[540] A limited number of other types of funds in DERA's sample also had aggregate exposures exceeding 150% of net assets. Funds that today operate with aggregate exposure far in excess of 150% of net assets (or, for certain leveraged ETFs or mutual funds, that seek to maintain a constant level of leveraged investments that require exposure in excess of 150%) could not continue operating as they do today under the proposed rule's 150% exposure limit. Furthermore, we do not expect that funds that use derivatives extensively in order to obtain market exposure generally would be able to satisfy the VaR test included in the risk-based limit.[541] These types of funds thus appear most likely to be affected by the proposed rule.

Some funds within this category of heavier derivatives users might be limited under the proposed rule from achieving high leverage through derivatives, and they might choose to

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539 *See, e.g.*, O'Hara, Wang & Zhou, *The Best Execution of Corporate Bonds*, Working Paper (Oct. 26, 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2680480 (finding that insurance companies trading in corporate bonds receive better execution prices if they are more active in the market, and that trading with a dominant dealer or underwriter worsens those differentials).

540 As discussed above, these funds are sometimes referred to as trading tools since they seek to provide a specific level of leveraged exposure to a market index over a fixed period of time.

541 *See supra* note 314 (explaining that a fund that holds only cash and cash equivalents and derivatives would not be able to satisfy the VaR test).

modify their investment activities or portfolio composition in order to comply with the proposed rule. They could do so in three principal ways. First, a fund could react to the proposed rule's conditions (*e.g.*, the restrictions on the amount of aggregate exposure a fund may obtain under the 150% and 300% exposure limits) by reducing its derivatives use below the relevant limit, or by declining to enter into transactions going forward that would exceed these limits. A fund that is compelled to react to the proposed rule and that does so by reducing its derivatives exposure would experience effects, including transactions costs, similar to those discussed above for a fund that reduces its derivatives exposure voluntarily.

Second, a fund that is limited by the proposed rule from achieving high leverage through derivatives might modify its investment activities by engaging in transactions that might involve leverage but not the issuance of a senior security that would be restricted by section 18 (*e.g.*, a purchased option). Some funds may also use fund of funds investment structures to seek leverage through investments in other funds, although the underlying funds in these arrangements also would be subject to the limitations in section 18 and the requirements of the proposed rule if those underlying funds are registered funds.[542] A fund may use these types of transactions to help it remain in compliance with the proposed rule, or avoid reliance on the proposed rule altogether. To the extent that a fund pursues leverage other than through a derivative that is subject to the proposed rule, the fund could incur transaction costs to close out positions covered by the proposed rule, and enter into new positions not covered by the proposed rule. These transaction costs are of the same nature as those discussed above for funds that

[542] The Investment Company Act also imposes limitations on fund of funds investments. *See*, *e.g.*, sections 12(d)(1)(A), (B) and (C) of the Investment Company Act. In addition, we understand that funds generally elect federal income tax treatment as a "regulated investment company" under Subchapter M of the Internal Revenue Code and that diversification requirements under Subchapter M may also limit certain fund of funds investments.

reduce their derivatives exposure in response to the new rule. Further costs for this option are the opposite of the discussion above with respect to shifting from cash-settled to physically-settled instruments: whereas there, investors could benefit from a more optimally-designed portfolio not subjected to regulatory arbitrage, here, investors may find it detrimental if the transactions entered into by funds to avoid the proposed rule were less efficient, or less calibrated to the fund's disclosed investment approach or risk/reward profile, than would otherwise be the case.

Third, a fund that is limited by the proposed rule from achieving high leverage through derivatives might modify its investment activities and reduce its use of derivatives by purchasing the securities underlying a derivative instrument (*e.g.*, purchasing the securities underlying an index future, rather than the index future itself). Derivatives can provide a lower-cost method of achieving desired exposures than purchasing the underlying reference asset directly. For example, a fund may use index futures as a cheaper means to gain exposure to certain markets or equitize cash, rather than purchasing the underlying equities included in the index.[543] Funds responding to the proposed rule in this manner would incur the incremental costs of trading constituent stocks of the index. As another example, a fund might also gain exposure to (or hedge) credit risk more cheaply through a credit default swap on an individual name or on a CDS

543 *See* 2010 ABA Derivatives Report, *supra* note 70, at 8 ("[W]hen a fund has a large cash position for a short amount of time, the fund can acquire long futures contracts to retain (or gain) exposure to the relevant equity market. When the futures contracts are liquid (as is typically the case for broad market indices), the fund can eliminate the position quickly and frequently at lower costs than had the fund actually purchased the reference equity securities.") For example, *See* Biswas, et al., *The Transaction Costs of Trading Corporate Credit*, Working Paper (Mar. 1, 2015) ("Transaction Costs of Trading Corporate Credit"), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2532805 ("For institutional-size trades up to $500K, bonds are up three times as expensive as the corresponding position using credit default swaps").

index rather than by purchasing or shorting bonds in the cash market.[544] To the extent that certain funds may be required to reduce their use of derivatives, these funds may experience higher trading costs. The transaction costs for exiting existing derivatives instruments are described in greater detail above. The costs of purchasing the underlying instruments can vary widely based on factors relating to the number and liquidity of the underlying instruments, in addition to the trading costs that various types of funds may incur in order to transact in the underlying instruments.[545] For example, transaction costs might make it more expensive to replace a total return swap on the S&P 500 by purchasing each of the underlying instruments, or even a sampling thereof, but a total return swap based on a narrower index might be more readily replaced.[546]

In addition to the direct effects on the fund of transacting in the derivatives rather than in the underlying assets, there are indirect effects. A fund that reduces its use of derivatives or replaces them with underlying assets may affect the fund's liquidity. We recognize that certain derivatives can be more liquid than their underlying reference assets. For example, it is cheaper to trade certain CDS contracts than to trade the underlying bonds.[547] In addition, some derivatives instruments may continue to trade during a broader stock market halt or during the

544 The 2010 ABA Derivatives Report, *supra* note 70, at 8, also observes that "a fund could write a CDS, offering credit protection to its counterparty. In doing so the fund gains the economic equivalent of owning the security on which it wrote the CDS, while avoiding the transaction costs that would have been associated with the purchase of the security."

545 *See supra* note 539.

546 In many cases, it is possible to obtain a proxy for an index return with only a subsample of the index constituents. While this option reduces the replication transaction cost, it introduces a tracking error and is unlikely to be as cost efficient as transacting in the total return swap. *See generally, e.g.*, Joel M. Dickson et al., *Understanding synthetic ETFs* Vanguard (June 2013), *available at* https://pressroom.vanguard.com/content/nonindexed/6.14.2013_Understanding_Synthetic_ETFs.pdf, at 9.

547 *See* The Transaction Costs of Trading Corporate Credit, *supra* note 543.

halt in the trading of a particular security. On the other hand, some derivatives may be less liquid than the underlying assets. For example, OTC swaps are tied to a specific counterparty and may be more customized; an OTC swap therefore may be less liquid than the underlying securities (which may be exchange traded and centrally cleared). Because the staff's data show that most funds in DERA's sample were below the 150% proposed exposure limitation, however, we expect that the proposed rule would not have a material effect on the way in which the majority of funds operate today, including how these funds manage their liquidity. Finally, if a number of funds were to respond to the proposed rule by shifting to purchasing the underlying assets, it is possible that demand for, and thus liquidity of, certain derivatives might be reduced while demand for, and liquidity of, the related underlying assets might be increased.

These three approaches all involve a fund changing its investment strategy in order to comply with the rule and are likely to have similar impacts on capital formation. A fund might seek to reduce its aggregate exposure by replacing a derivative with the underlying security. As a result, the overall demand for the underlying securities may increase and therefore promote capital formation, assuming that those underlying securities would not themselves have been held by the counterparty to the fund's derivative contract to hedge that exposure.[548] On the other hand, if a fund is unable to use derivatives to mitigate or eliminate certain risks posed by its portfolio securities, a fund may find it less desirable to hold such securities, adversely affecting capital formation by potentially reducing demand for debt and equity securities.[549] A reduction in the use of derivatives may adversely affect the pricing efficiency of underlying reference

548 For example, a fund that obtains synthetic long exposure to a corporate debt instrument by writing a credit default swap may decide, instead, to hold the debt instrument directly.

549 For example, if a fund can no longer use a credit default swap to help mitigate credit risk, the fund might be less willing to hold a high-yield bond, which may affect the issuance of high-yield bonds.

securities,[550] thereby adversely affecting capital formation. In addition, to the extent that a reduction in the use of derivatives adversely affects pricing efficiency or transparency, it may become more difficult for a fund (or its third-party pricing service) and its board of directors to determine fair values where necessary. As we discuss below, however, we believe that the proposed rule would affect only the small percentage of funds that use derivatives to a much greater extent than funds generally, and thus, any such aggregate effects are not likely to be significant.[551]

Other funds that use derivatives extensively, including the types of funds discussed above (as those most likely to be impacted by the proposed rule), may be unable to scale down their aggregate exposures or otherwise de-lever their funds in a way that allows the fund to maintain its investment objectives or provide a product that has sufficient investor demand. Such a fund may choose to deregister under the Act and liquidate, and/or the fund's sponsor may choose to offer the fund's strategy as a private fund or (public or private) commodity pool.

For example, a fund that must reduce its aggregate exposure may not be able to offer the returns (and risks) that some investors demand. ETFs (or other funds) that use derivatives to obtain a leveraged multiple of the performance (or inverse performance) of an index and that require exposures in excess of 150% of net assets could not operate in their current form under the proposed rule, and may not have sufficient demand at lower exposure levels. Some of these

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550 For example, option listings may incentivize market analysts to research the underlying securities. Options trading may also facilitate market pricing of the underlying securities. *See* Arrata William, Alejandro Bernales & Virginie Coudert, *The Effects of Derivatives on Underlying Financial Markets: Equity Options, Commodity Derivatives and Credit Default Swaps*, SUERF 50TH ANNIVERSARY VOLUME 445 (2013).

551 To the extent that aggregate derivatives usage by funds is small compared to the world-wide derivatives market (*see supra* note 518), and to the extent that only some fraction of derivatives usage by funds would potentially be affected, the expected effect on the world-wide derivatives market would be negligible.

funds therefore may be liquidated or merged into other funds.

As discussed above, however, alternative strategy funds and certain leveraged ETFs (the types of fund most likely to be particularly affected by the proposed rule) represent a very small percentage of fund assets under management—approximately 3% of all fund assets.[552] Only a small subset of funds—primarily managed futures funds and leveraged ETFs—would appear to be unable to operate as they do today while complying with the proposed rule's aggregate exposure limits.[553] Therefore, we believe that the number of funds that may be unable to scale down their aggregate exposures or otherwise de-lever their funds in a way that allows the funds to maintain their investment objectives or provide a product that has sufficient investor demand—*i.e.*, those that may have to pursue deregistration and liquidation—would be limited in many instances to the small percentage of funds that use derivatives to a much greater extent than funds generally, and would not be significant to the industry as a whole.

In the event that a fund is unable to operate under the proposed rule's aggregate exposure limit, the fund's sponsor and/or investment adviser may choose to: (i) offer the fund as a private fund or (public or private) commodity pool; (ii) liquidate the fund's assets and deregister the fund under the Act; or (iii) merge the fund into another fund. We estimate that the average cost

552 *See* DERA White Paper, *supra* note 73, Table 1.

553 Based on our staff's review of fund filings with the Commission and Morningstar data, we estimate that there are approximately 60 managed futures funds. Based on information from ETF.com, we estimate that there are 43 2x leveraged ETFs and 36 2x inverse ETFs (79 total), and 36 3x leveraged ETFs and 28 3x inverse ETFs (64 total). We note that some funds that seek to deliver two times the performance of an index may be able to achieve this level of exposure in compliance with the proposed rule's 150% exposure limit by investing in securities included in the benchmark index and obtaining additional exposure through derivatives transactions. Although we understand that most of the funds that seek to achieve performance results, over a specified period of time, that are a multiple of or inverse multiple of the performance of an index or benchmark are ETFs, some mutual funds also pursue these strategies. These mutual funds would be affected to same extent by the proposed rule as leveraged ETFs.

associated with such actions would range from $30,000 to $150,000, per fund, depending on the particular actions taken by the fund (or its sponsor or investment adviser).[554] These costs are the direct costs to the fund. There are also indirect costs associated with a fund's decision to deregister and for the fund's sponsor to offer the fund's strategy as a private fund or public or private commodity pool. To the extent that a fund becomes unavailable to investors, or available only at a higher cost, investors and competition will be adversely affected. For example, non-accredited investors generally would not be able to purchase interests in equivalent unregistered funds. However, accredited investors who prefer unregistered funds, or who are agnostic about the form, could have the same or greater choice of funds, and competition among funds offering similar investment objectives or risk/return profiles as private funds may increase. Similarly, registered funds that choose to operate as public commodity pool investment partnerships, rather than SEC-registered funds, would be accessible to a broad population of investors. In addition, investment advisers, counterparties, and other market participants whose business is concentrated on offering, managing, or servicing these type of funds may similarly be adversely affected.[555] For example, it could mean substantially lower management fees for advisers whose advisory business primarily involves funds that would be unable to operate under the proposed rule's exposure limits. It also could mean higher management and/or performance fees if the new investment vehicle is a private fund. To the extent that these parties are adversely affected,

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554 This estimate is based on staff outreach and experience and includes, for example: time costs to consult with appropriate personnel of the investment adviser (*e.g.*, portfolio managers and other senior management) and prepare the necessary documentation (*e.g.*, documents related to fund liquidation, fund formation, fund registration (general counsel and chief compliance officer); time costs to obtain required fund board approvals; internal and external costs related to required shareholder approvals; and external costs for a fund's and/or fund board's outside legal counsel. We note that a fund may incur costs substantially higher or lower than our estimates, based on the size and complexity of the fund.

555 *See supra* note 551.

competition also could be negatively affected. We are unable to quantify these indirect costs because we cannot determine the extent to which adequate substitutes would exist in the market.

The proposed rule's aggregate exposure limits may, in certain situations, constrain a fund's ability to use derivatives as a hedge in connection with its investment strategies. Although the analysis conducted by DERA staff indicates that most funds do not today have aggregate exposure in excess of the proposed rule's 150% and 300% exposure limitations, it is possible that a fund that uses a substantial amount of derivatives could be in a position where it could not engage in additional derivatives transactions, including as a portfolio hedge in certain circumstances. A fund that reaches the proposed aggregate exposure limits would not be permitted to enter into additional derivatives transactions unless the fund would be in compliance with the applicable exposure limitation immediately after entering into each transaction. As a consequence, it is possible that a fund may need to limit its derivatives transactions, or close out existing derivatives positions, in order to retain flexibility to enter into risk mitigating derivatives transactions at a later date. Alternatively, a fund may, in certain circumstances, refrain from derivatives transactions that it expects would be risk mitigating, which could potentially have the effect of increasing a fund's risks.

For example, it is possible that a fund that complies with the risk-based portfolio limit's VaR test could be precluded from entering into additional derivatives to protect against a particular risk if the fund had reached the risk-based portfolio limit's 300% limit on aggregate exposure. Such a limitation would appear to apply only if the fund engages in extensive use of derivatives. For example, a bond fund could seek to protect its portfolio against 100% of its interest rate risk and currency risk through derivatives transactions and also seek to hedge a substantial amount of its credit risk while still having room under the 300% limit to seek to hedge other risks such as inflation risk.[556] We acknowledge that any limitation, such as the 300% exposure limit in the risk-based portfolio limit, may constrain a fund's ability to implement its strategy, and in particular circumstances, may require a fund to take actions other than adding additional derivatives to manage and reduce portfolio risks. In such a circumstance, a fund may experience greater returns, albeit with greater risk, if the fund is unable to enter into additional hedging transactions because it has reached the 300% limit. A fund may decide to maintain the riskier position, shift away from the underlying assets that it had previously sought to hedge (so as to maintain its previous level of risk), or hedge against the risk using instruments not within the scope of this rule. Because we are unable to reasonably anticipate the ways in which a fund is likely to respond to the 300% limitation, we are unable to quantify the expected impact of the portfolio limitation on a fund's returns.[557]

Proposed rule 18f-4 would also require a fund that engages in financial commitment transactions in reliance on the rule to maintain qualifying coverage assets equal in value to the fund's full obligations under those transactions. The proposed rule generally would take the same approach to financial commitment transactions that we applied in Release 10666, with some modifications discussed above in III.E. The proposed rule's requirements for financial commitment transactions, similar to the approach we applied in Release 10666, would limit the extent to which a fund could engage in financial commitment transactions, in that the fund could

[556] For example, the fund could enter into interest rate derivatives with a notional amount of 100% of the fund's net assets in order to seek to hedge interest rate risk; enter into currency derivatives with a notional amount of 100% of the fund's net assets in order to seek to hedge currency risk; and enter into credit derivatives with a notional value that is less than 100% of the fund's net assets to seek to hedge credit risk. The fund in this example would have aggregate exposure of something less than 300% and thus could obtain some additional derivatives exposure—up to the 300% aggregate limit—provided the fund complied with the VaR test under the risk-based portfolio limit and the proposed rule's other conditions.

[557] *See* text surrounding *supra* note 534.

not incur obligations under those transactions in excess of the fund's qualifying coverage assets. This would limit a fund's ability to incur obligations under financial commitment transactions to 100% of the fund's net assets, as discussed above in III.E. We believe that the proposed rule is not likely to impose any significant additional limitation on the extent to which a fund can incur obligations under financial commitment transactions (as compared with the current economic baseline) because, as noted above, funds that enter into these transactions today do so in reliance on Release 10666, which generally would limit the fund's obligations under these transactions to the fund's net assets.[558] This is consistent with DERA staff's analysis, which showed that no fund in the DERA sample had greater than 100% aggregate exposure resulting from financial commitment transactions (the current economic baseline for such transactions).[559] Accordingly, we believe that the proposed rule's asset segregation requirements for financial commitment transactions would have no measurable effect on efficiency, competition, or capital formation.

We also note that the proposed asset segregation requirements, to the extent that a fund is required to increase its holdings of cash and cash equivalents (for derivatives transactions) or assets convertible to cash or that can generate cash (for financial commitment transactions), may adversely affect efficiency, competition, and capital formation. For example, holding higher levels of these assets may reduce efficiency by requiring a fund's investment adviser to invest the fund's assets in cash and cash equivalents or assets convertible to cash or that can generate cash to a greater extent than the adviser otherwise would invest the fund's assets, given the fund's investment strategy and investor base. This, in turn, could adversely affect investors by reducing a fund's investment returns, and reduce competition by decreasing a fund's investment

558 *See supra* note 93 and accompanying text.

559 DERA White Paper, *supra* note 73, Table 6.

opportunities to generate higher returns. In addition, a fund that holds greater amounts of cash and cash equivalents (all other things, such as fund flows, being equal) necessarily holds a smaller amount of securities in its portfolio, which may adversely affect capital formation. As discussed in Section III.C.2 above, however, we understand that cash and cash equivalents are commonly used for posting collateral or margin for derivatives transactions.[560] Also, given that the margin posted is permitted to be offset against the assets that would be required to be segregated under the proposed rule, the magnitude of funds' shift into cash and cash equivalents under the proposed rule may not be as significant as it would be otherwise, thereby mitigating the negative impact on capital formation that the asset segregation requirements of the proposed rule may cause.

Finally, we note that the size of a fund, or the complex of funds to which a fund belongs, could have certain competitive effects with respect to a fund's compliance with proposed rule 18f-4, including the implementation of its derivatives risk management program, where applicable. For example, if there are economies of scale in creating and administering multiple derivatives risk management programs, a fund that is part of a large fund complex would have a competitive advantage. A fund in a smaller complex, on the other hand, may use a greater portion of its resources to create and administer a derivatives risk management program, which may increase barriers to entry in the fund industry, and lead to an adverse effect on competition. The size of a fund complex also could produce competitive advantages or disadvantages with respect to a fund's use of products developed by third parties to assist a fund in calculating and monitoring its compliance with the proposed rule's portfolio limitations and asset segregation requirements. For example, a fund in a large complex could receive relatively more favorable

560 *See supra* note 370 and accompanying text.

pricing for third-party risk management tools, if the fund complex were to purchase discounted bulk services from the tool developer or receive relationship-based pricing discounts. Regardless of the extent to which a third-party provides its product at a discounted rate, the proposed rule may positively impact third-party service providers by increasing sales. We note that the competitive effects discussed above in the context of funds and/or fund families may, instead, apply to a fund's investment adviser. This may occur where the investment adviser (rather than the fund) incurs the costs associated with implementing the proposed rule's requirements, and does not, or is unable to, pass such costs along to the fund (for example, through increases in its advisory fees).

### D. Specific Benefits and Quantifiable Costs

We have discussed above a number of general benefits and costs, including effects on efficiency, competition, and capital formation that we believe would generally result from the proposed rule. Taking into account the goals of the proposed rule and the economic baseline, as discussed above, this section explores specific benefits and quantified costs, in the context of each core element of the proposed rule.

We note that the following analyses and estimates are made on a per fund basis, and are not made on a fund complex basis. We have made these estimates on a per fund basis because the DERA sample analysis upon which we rely in our economic analysis was performed at a fund level. In addition, we believe that the extent of derivatives use varies widely between funds. Accordingly, we believe that estimating costs on a per fund basis is likely to provide more meaningful estimates, consistent with the approach taken in the DERA sample. We recognize, however, that many funds are part of a fund complex, and thus may realize economies of scale in complying with the proposed rule.[561] As discussed below, our estimated ranges of per fund costs take this into account. The low end of our range of costs reflects the estimated costs for a fund that is part of a fund complex (which is likely to experience economies of scale), while the high end of our range of costs reflects the estimated costs likely borne by a stand-alone fund that is not part of a fund complex or that is the only fund in a complex that relies on the rule.

### 1. *Exposure-Based Portfolio Limit*

#### a. Requirements

As discussed above in section III.B.1, the proposed rule would require that a fund that engages in derivatives transactions in reliance on the rule comply with one of two alternative portfolio limitations. The first portfolio limitation—the exposure-based portfolio limit—would place an overall limit on the amount of exposure to underlying reference assets, and potential leverage, that a fund would be able to obtain from derivatives transactions covered by the proposed rule by limiting the fund's exposure under these derivatives transactions and other senior securities transactions to 150% of the fund's net assets.

#### b. Benefits

The 150% aggregate exposure limit in the exposure-based portfolio limit (as well as the 300% exposure limit in the risk-based portfolio limit discussed below) is designed primarily to impose an overall limit on the amount of exposure to underlying reference assets, and potential leverage, that a fund would be able to obtain through derivatives subject to the rule and other senior securities transactions, while also providing flexibility for a fund to use derivatives for a variety of purposes.[562] An outer limit on aggregate exposure would prevent funds from obtaining

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561 The extent of the economies of scale may depend, in part, on the extent to which multiple funds in the same fund complex use derivatives transactions and financial commitment transactions in similar ways.

562 The proposed rule's portfolio limitations, although designed to impose a limit on potential

extremely high leverage that we believe may be inconsistent with the Act's stated concern about senior securities that increase unduly the speculative nature of a fund's outstanding securities. The proposed rule, therefore, is expected to benefit investors by providing a clear and workable framework in which funds may continue to use derivatives covered by the proposed rule for a variety of purposes, but subject to a limit on the potential leverage (and leverage-related risks) that could be obtained through these covered instruments. By explicitly limiting a fund's aggregate exposure from derivatives and other senior securities transactions, the proposed rule also may reduce the likelihood of extreme fund losses associated with leveraged portfolios under stressed market conditions. As a result, the proposed rule may reduce the possibility of a fund needing to liquidate and the associated adverse impacts on market participants and thus may promote market stability.[563] As we discussed above, the DERA staff analysis also indicates that most funds and their advisers would be able to continue to operate and to pursue a variety of investment strategies, including alternative strategies (under the 150% exposure limitation).[564]

The proposed rule's definition of exposure for derivatives transactions would require that a fund aggregate the notional amounts of those derivatives (with certain adjustments specified in the proposed rule).[565] For most types of derivatives, the notional amount can serve as a measure

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leverage, also could help to address concerns about a fund's ability to meet its obligations, as noted above. *See supra* note 152.

563 While we lack empirical evidence that a registered fund's liquidation under stressed market conditions, including the potential forced sale of assets, could have adverse effects on market participants, we believe that the avoidance of potential negative externalities from a fund's liquidation into a stressed market broadly promotes market resiliency and stability.

564 *See supra* note 210 and accompanying text.

565 The proposed rule includes certain adjustments to the way in which a fund would generally be required to determine the "notional amount" with respect to its derivatives transactions. For any derivatives transaction that provides a return based on the leveraged performance of a reference asset, the notional amount must be multiplied by the leverage factor; for any derivatives transaction for which the reference asset is a managed account or entity formed primarily for the

of the fund's investment exposure to the derivative's underlying reference asset or metric. While there are other measures that could be used, the notional amount is a measure that is well-understood and recognized, and readily determinable by funds.[566] In addition, the notional amount is a measure for determining exposure that is adaptable to different types of fund strategies or different uses of derivatives, including types of fund strategies and derivatives that may be developed in the future. Funds, particularly smaller or less sophisticated funds, may benefit from the ease of application of a bright-line, straightforward metric such as this one, as compared to a test that would require consideration of the manner in which a fund uses derivatives in its portfolio (*e.g.*, whether particular derivatives are used for hedging.

c. Quantified Costs

Funds that elect to rely on the rule would incur one-time and ongoing operational costs to establish and implement a 150% exposure-based portfolio limitation.[567] As discussed above,

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purpose of investing in derivatives transaction, or an index that reflects the performance of such a managed account or entity, the notional amount must be determined by reference to the fund's pro rata share of the notional amounts of the derivatives transactions of such account or entity ("look-through provision"); and for any "complex derivatives transaction," (defined in rule 18f-4(c)(1) and discussed above in section III.B), the notional amount must be an amount equal to the aggregate notional amount of derivatives instruments, excluding other complex derivatives transactions, reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction. *See* proposed rule 18f-4(c)(7)(iii)(C). The estimated operational costs associated with these aspects of the proposed rule are included in our cost estimates discussed below in section IV.D.1.c.

566 *See, e.g.*, Michael Chui, *Derivatives markets, products and participants: an overview* (Bank of International Settlements, IFC Bulletin No. 35 (Feb. 2012), available at http://www.bis.org/ifc/publ/ifcb35a.pdf ("Notional amount is the total principal of the underlying security around which the transaction is structured. It is easy to collect and understand.").

567 As discussed below in section IV.D.4, a fund that seeks to rely on the proposed rule would not be required to have a derivatives risk management program provided the fund limits its aggregate exposure from derivatives transactions to no greater than 50% of the fund's net assets (and does not use complex derivatives transactions). The costs that we estimate here for a fund to comply with the 150% exposure-based portfolio limit would include the costs for a fund to determine and monitor its compliance with the proposed 50% exposure-based test (and complex derivatives transaction limitation) for establishing a derivatives risk management program.

funds today employ a range of different practices, with varying levels of comprehensiveness, for complying with section 18's prohibitions, Commission positions, and staff guidance. Although the 150% exposure-based portfolio limit would be new for all funds that seek to comply with the proposed rule, we anticipate that the relative costs to a particular fund are likely to vary, depending on the extent to which a fund enters into derivatives transactions, and, for example, the level of sophistication of a fund's current risk management processes surrounding its use of derivatives.

The extent to which a fund currently engages in derivatives transactions may affect the costs the fund would incur. For example, funds that today use derivatives more extensively may already have systems that can be used to determine a fund's exposure or that could more readily be updated to include that functionality. Proposed Form N-PORT would require funds to report the notional amounts of certain derivatives on the form and, if we adopt Form N-PORT, the systems or enhancements put in place by funds in connection with Form N-PORT's reporting requirements may provide an efficient means to calculate notional amounts for proposed rule 18f-4. Conversely, a fund that uses derivatives only modestly may not have existing systems that can be as readily used to determine a fund's exposure, but a fund that uses derivatives modestly may be able to determine its exposure without the need to establish the kinds of more extensive systems that might be required or desired by funds that use derivatives more extensively.

The types of derivatives a fund uses also may affect the costs the fund would incur. Funds that enter into complex derivatives transactions, as defined in the proposed rule, would be required to determine the notional amounts of those transactions using the alternative approach specified in the proposed rule for complex derivatives transactions. Under this approach, the notional amount of a complex derivatives transaction would be equal to the aggregate notional amount(s) of derivatives instruments, excluding other complex derivatives transactions, reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction at the time the fund enters into the transaction.[568] It may require additional resources or analysis to determine a complex derivative's notional amount than, for example, a non-complex derivatives transaction with a stated notional amount that can be used for purposes of the proposed rule's exposure limitations. It may similarly require additional resources or analysis to determine the notional amount of a derivatives transaction for which the reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity, because the notional amount of such a derivatives transaction under the proposed rule would be determined by reference to the fund's pro rata share of the notional amounts of the derivatives transactions of such account or entity.[569] In any case, the costs associated with the exposure-based portfolio limit would directly impact funds (and may indirectly impact fund investors if a fund's adviser incurs costs and passes along its costs to investors through increased fees).

Our staff estimates that the one-time operational costs necessary to establish and implement an exposure-based portfolio limitation would range from \$20,000 to \$150,000[570] per

[568] Proposed rule 18f-4(c)(7)(iii)(C).

[569] Proposed rule 18f-4(c)(7)(iii)(B).

[570] These cost estimates, and the other quantified costs discussed below, are based, in part (adjusting such estimates to reflect specific provisions of the proposed rule), on staff experience and outreach, as well as consideration of recent staff estimates of the one-time and ongoing systems costs associated with other Commission rulemakings. *See*, *e.g.*, 2014 Money Market Fund Reform Adopting Release, *supra* note 367, at sections III.A.5 and III.B.8 (estimating the one-time and ongoing operational costs to money market funds and others in the distribution chain to

fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund.[571] These estimated costs are attributable to the following activities: (i) developing and implementing policies and procedures[572] to comply with the proposed rule's 150% exposure-based portfolio limit; (ii) planning, coding, testing, and installing any system modifications relating to the 150% exposure-based portfolio limitation;[573] and (iii) preparing training materials and administering training sessions for staff in affected areas.

Our staff estimates that a fund that is part of a fund complex will likely benefit from economies of scale and incur costs closer to the low-end of the estimated range of costs, while a standalone fund is more likely to incur costs closer to the higher-end of the estimated range of costs. Our staff also estimates that a standalone fund that is a light or moderate user of

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modify systems and implement certain reforms including liquidity fees and gates and/or a floating NAV); Liquidity Release, *supra* note 5, at section IV.C.1 (estimating the one-time and ongoing operational costs to most registered open-end funds to modify systems and implement new proposed rule 22e-4, requiring a liquidity risk management program). Although the substance and content of systems associated with establishing and implementing policies and procedures to comply with proposed rule 18f-4 would be different from the substance and content of systems associated with, for example, implementing the money market fund reforms or a new proposed liquidity risk management program, the costs associated with the core requirements of proposed rule 18f-4, like the 2014 adopted money market fund reforms and the 2015 proposed liquidity risk management program reforms, would entail: developing and implementing policies and procedures; planning, coding, testing, and installing any relevant system modifications; and preparing training materials and administering training sessions for staff in affected areas.

571 We estimate that the costs discussed throughout this section would apply equally across affected fund types, including open-end funds, closed-end funds, ETFs, and BDCs.

572 Throughout this economic analysis, we include in "developing and implementing policies and procedures" cost estimates (both for initial and ongoing costs) associated with internal and external costs (*e.g.*, compliance consultants, outside legal counsel), as well as staff costs (*e.g.*, legal, compliance, portfolio management, risk management, and other administration personnel).

573 Throughout this economic analysis, these cost estimates assume that affected funds would incur systems costs (*i.e.*, computer-based systems costs) to assist them in complying with the requirements of proposed rule 18f-4. As discussed below, some funds may determine that computer-based systems are not required (*e.g.*, the fund engages only in limited amounts of derivatives transactions for which notional exposures are easily determinable) and choose to implement a less automated system for complying with the proposed rule's requirements. We expect that such a fund would not incur costs related to this particular activity, and more likely, would incur total costs closer to the lower-end of the estimated range of costs.

derivatives may choose to comply with the proposed rule by implementing a less automated system, and thus be more likely to incur costs closer to the low-end of the estimated range of costs. We anticipate that if there is demand to develop systems and tools related to the exposure-based portfolio limitation, market participants (or other third parties) may develop programs and applications that a fund could purchase at a cost likely less than our estimated cost to develop the programs and applications internally. In addition, the proposed rule may increase the demand for information services relating to derivatives to the extent that funds and advisers use third-party providers of such information services, such as risk management tools (*e.g.*, VaR measures) and pricing data, and thus could potentially affect these third-party providers as well.

Staff also estimates that each fund would incur ongoing costs related to implementing a 150% exposure-based portfolio limitation under proposed rule 18f-4. Staff estimates that such costs would range from 20% to 30% of the one-time costs discussed above.[574] Thus, staff estimates that a fund would incur ongoing annual costs associated with the 150% exposure-based portfolio limit that would range from \$4,000 to \$45,000.[575] These costs are attributable to the following activities: (i) complying with the proposed rule's 150% aggregate exposure limit; (ii) systems maintenance; and (iii) additional staff training.

In the DERA staff analysis, 68% of all of the sampled funds did not have any exposure to derivatives transactions.[576] These funds thus do not appear to use derivatives transactions or, if

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574 *See supra* note 570. In estimating the total quantified costs of our proposed rule, we estimate that the portfolio limitation requirements would likely impose initial costs that are proportionately larger than ongoing costs. Accordingly, and based on staff experience and outreach, we estimate that the ongoing costs would range from 20% to 30% of the initial costs.

575 This estimate is based on the following calculations: 0.20 x \$20,000 = \$4,000; 0.30 x \$150,000 = \$45,000.

576 DERA White Paper, *supra* note 73, Figure 11.1. As discussed above, we recognize that the DERA staff analysis used a sample of funds and reviewed the funds' then-most recent annual

they do use them, do not appear to do so to a material extent. We therefore estimate that approximately 32% of funds—the percentage of funds that did have derivatives exposure in the DERA sample—are more likely to enter into derivatives transactions and therefore are more likely to incur costs associated with either the exposure-based portfolio limit or the risk-based portfolio limit. Excluding approximately 4% of all funds (corresponding to the percentage of sampled funds that had aggregate exposure of 150% or more of net assets and for which we have estimated costs for the risk-based limit),[577] we estimate that 28% of funds (3,352 funds[578]) would incur the costs associated with the exposure-based portfolio limit.

As discussed above, we have not aggregated the estimated range of costs across the entire fund industry. We note, however, that the vast majority of funds operate as part of a fund complex, and therefore we expect that many funds would achieve economies of scale in implementing the proposed rule. Accordingly, we believe that the lower-end of the estimated range of costs ($20,000 in one-time costs; $4,000 in annual costs) better reflects the total costs

reports. The number of funds that may enter into senior securities transactions may be higher or lower than our estimate. We believe, however, that the results of the DERA staff analysis provide a reasonable basis to estimate the extent to which funds engage in derivatives and other senior securities transactions, and thus provide a reasonable basis to estimate the potential costs of the proposed rule to funds.

577 DERA White Paper, *supra* note 73, Figure 9.1.

578 This estimate is based on the following calculation: 11,973 funds x 28% = 3,352 funds. The number of funds is based on the following calculation, as of June 2015: (9,707 open-end funds + 560 closed-end funds +1,706 ETFs = 11,973). *See supra* note 511 and accompanying text. In estimating the potential costs to funds related to their use of derivatives (both here and throughout this Release), we have estimated the total fund universe excluding money market funds and BDCs because money market funds do not enter into derivatives transactions and because we understand, and the DERA staff analysis shows, that BDCs do not use derivatives to a material extent (no BDC in the DERA staff sample had exposures to derivatives transactions). We have considered, however, the potential costs on these funds to the extent that such funds use financial commitment transactions (*see supra* section IV.D.5), and if a BDC were to engage in derivatives transactions, we expect that the BDC would incur the costs estimated here and throughout this Release for funds that engage in derivatives transactions.

likely to be incurred by many funds.

As noted above, based on the DERA sample, 68% of all sampled funds (8,142 funds[579]) do not appear to use derivatives transactions (or if they do, do not appear to use them to a material extent). We do, however, recognize that although we do not estimate costs for these funds to comply with the proposed rule, some of these funds may wish to preserve the flexibility to do so in the future. Accordingly, we estimate that a fund that would otherwise not comply with proposed rule 18f-4 would incur approximately $10,000 to evaluate the proposed rule and for the fund's board to consider approving the fund's use of the exemption provided by the rule (and therefore preserve the flexibility to comply in the future).[580]

### 2. *Risk-Based Portfolio Limit*

#### a. Requirements

As discussed above in section III.B.2, the proposed rule would require that a fund that engages in derivatives transactions in reliance on the rule comply with one of two alternative portfolio limitations. The second portfolio limitation is the risk-based portfolio limit, which would focus primarily on a risk assessment of the fund's use of derivatives, and would permit a fund to obtain exposure in excess of that permitted under the first portfolio limitation where the fund's derivatives transactions, in the aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives, evaluated using a VaR-based test.

#### b. Benefits

The principal benefit of the risk-based portfolio limit is that it recognizes that funds may

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579 This estimate is based on the following calculation: 11,973 funds x 68% = 8,142 funds.

580 This estimate is based on staff outreach and experience and includes estimates for time spent by a fund's chief compliance officer, consultation with portfolio managers and other senior management of the fund's adviser, as well as the fund's board of directors.

use derivatives to not only seek higher returns through increased investment exposures, but importantly, also as a low-cost and efficient means to reduce and/or mitigate risks associated with the fund's portfolio. Some funds may have or develop investment strategies that include the use of derivatives that, in the aggregate, have relatively high notional amounts, but that are used in a manner that could be expected to reduce the fund's exposure to market risk rather than to increase exposure to market risk through the use of leverage. We expect that investors, and the markets in general, would benefit from an alternative portfolio limitation that focuses primarily on a risk assessment of a fund's use of derivatives, in contrast to the exposure-based portfolio limit, which focuses solely on the level of a fund's exposure. We also expect that funds should benefit from having the flexibility to select a VaR model that best addresses the funds' particular investment strategy and the nature of its portfolio investments, while also specifying certain minimum requirements in the proposed rule.[581]

In addition to the VaR test, the risk-based portfolio limit also includes an outer limit on aggregate exposure. Investors should also benefit from a flexible approach that allows for greater aggregate exposure (as compared with the 150% exposure-based portfolio limitation), and thus may promote the use of derivatives when, in aggregate, the result is an investment portfolio that is subject to less market risk than if the fund did not use such derivatives. Including an outer exposure limit, in addition to the VaR test, should provide benefits similar to those discussed above in section IV.D.1. Those benefits include improved investor protection, increased market stability through explicit limitations on potential leverage, and an exposure calculation that uses notional amounts that are widely available and adaptable to the varied types of derivatives instruments used by funds. We also believe that increasing the aggregate exposure

581 *See supra* sections III.b.2.a, b.

limit from 150% (under the exposure-based portfolio limitation) to 300% of net assets when a fund's use of derivatives, in aggregate, has the effect of reducing the fund's exposure to market risk, should benefit investors by permitting funds to engage in increased use of derivatives to mitigate risks in the fund's portfolio.[582] Setting the exposure limit at 300% as part of the risk-based portfolio limit would provide a limit for funds that could seek to operate under the risk-based portfolio limit that permits additional capacity for hedging transactions while still setting an overall limit on the amount of leverage that can be obtained through derivatives that are subject to the rule. Moreover, based on the DERA staff analysis, many of the funds with aggregate exposure in excess of 300% of net assets appear to use derivatives primarily to obtain market exposure (rather than to reduce the fund's exposure to market risk).[583]

c. Quantified Costs

As with the quantified costs we discuss above regarding the exposure-based portfolio limit (section IV.D.1), we expect that funds would incur one-time and ongoing operational costs to establish and implement a risk-based exposure limit, including the VaR test. We expect that a fund that seeks to comply with the 300% aggregate exposure limit would incur the same costs as those that we estimated above in order to establish and implement the 150% exposure-based portfolio limit.[584] Accordingly, we estimate below the costs we believe a fund would incur to comply with the VaR test. Although the VaR test and outer limit on aggregate exposure would be new for all funds that seek to comply with the proposed rule's risk-based exposure limit, we anticipate that the costs to a particular fund are likely to vary, depending on the extent to which a

582 *See supra* note 239 and accompanying text (acknowledging that a hedging transaction may not always result in mitigating risk).

583 *See supra* note 314.

584 The only difference would be an increased outer limit of aggregate exposure (from 150% to 300% of the fund's net asset value).

fund enters into derivatives transactions and the level of sophistication of a fund's existing risk management processes surrounding its use of derivatives. For example, funds that use derivatives extensively may already use a VaR model to evaluate and monitor the risks associated with derivatives transactions. As a result, these funds may incur lower costs as compared with other funds that do not already have sophisticated tools in place to monitor the risks associated with derivatives. In this regard, we note that funds that would seek to comply with the risk-based portfolio limit, rather than the exposure-based portfolio limit, may be more likely to be more extensive users of derivatives because we expect that less extensive derivatives users generally would choose to operate under the exposure-based portfolio limit. These costs would directly impact funds (and may indirectly impact fund investors if a fund's adviser incurs costs and passes along its costs to investors through increased fees).

Our staff estimates that the one-time operational costs necessary to establish and implement a VaR test would range from $60,000 to $180,000[585] per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund. These estimated costs are attributable to the following activities: (i) developing and implementing policies and procedures to comply with the proposed rule's requirement that the fund's full portfolio VaR is less than the fund's securities VaR; (ii) planning, coding, testing, and installing any system modifications relating to the VaR test; and (iii) preparing training materials and administering training sessions for staff in affected areas.

Our staff estimates that a fund that is part of a fund complex would likely benefit from economies of scale and incur costs closer to the low-end of the estimated range of costs, while a standalone fund is more likely to incur costs closer to the higher-end of the estimated range of

585 *See supra* note 570.

costs. Our staff also estimates that a standalone fund that is a light or moderate user of derivatives may choose to comply with the proposed rule by implementing a less automated system, and thus be more likely to incur costs closer to the low-end of the estimated range of costs. We anticipate that if there is demand to develop systems and tools related to the risk-based portfolio limitation, market participants (or other third parties) may develop programs and applications that a fund could purchase at a cost likely less than our estimated cost to develop the programs and applications internally.

Staff also estimates that each fund would incur ongoing costs related to implementing a VaR test under proposed rule 18f-4. Staff estimates that such costs would range from 20% to 30% of the one-time costs discussed above.[586] Thus, staff estimates that a fund would incur ongoing annual costs associated with the VaR test aspect of the risk-based exposure limit that would range from $12,000 to $54,000.[587] These costs are attributable to the following activities, as applicable to each fund: (i) complying with the VaR test (*i.e.*, that, immediately after entering into any senior securities transaction, the fund's full portfolio VaR is less than the fund's securities VaR); (ii) systems maintenance; and (iii) additional staff training.

DERA staff analysis shows that approximately 4% of all funds sampled had aggregate exposure of 150% or more of net assets.[588] We estimate, therefore, that 4% of funds (479 funds[589]) may seek to comply with the risk-based portfolio limit.[590] As with the other quantified

586 *See supra* notes 570 and 574.

587 This estimate is based on the following calculations: 0.20 x $60,000 = $12,000; 0.30 x $180,000 = $54,000.

588 DERA White Paper, *supra* note 73, Figure 9.1.

589 This estimate is based on the following calculation: 11,973 funds x 4% = 479 funds. *See also supra* note 578.

590 We recognize, however, that it is possible that some (or all) of these funds may decide, after

costs we discuss in this Release, we believe that many funds belong to a fund complex and are likely to experience economies of scale. We therefore expect that the lower-end of the estimated range of costs ($60,000 in one-time costs; $12,000 in annual costs) better reflects the total costs likely to be incurred by many funds.

### 3. *Asset Segregation*

#### a. Requirements

As discussed above in section III.C, the proposed rule would require a fund that seeks to enter into derivatives transactions to manage the risks associated with its derivatives transactions by maintaining an amount of certain assets, defined in the proposed rule as "qualifying coverage assets," designed to enable the fund to meet its obligations under such transactions. To satisfy this requirement the fund would be required to maintain qualifying coverage assets to cover the fund's mark-to-market obligations under a derivatives transaction (the "mark-to-market coverage amount," as noted above), as well as an additional amount, determined in accordance with policies and procedures approved by the fund's board, designed to address potential future losses and resulting payment obligations under the derivatives transaction (the "risk-based coverage amount," as noted above).

#### b. Benefits

The proposed asset segregation will likely improve a fund's ability to meet its obligations under its derivatives transactions. The proposed rule's requirement that the fund maintain qualifying coverage assets with a value equal to the fund's mark-to-market coverage amount is designed to require the fund to have assets sufficient to meet its obligations under the derivatives

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evaluating the particularized costs and benefits, to reduce (or even eliminate) their use of such transactions and therefore rely on the 150% exposure-based portfolio limitation, or not rely on proposed rule 18f-4 at all. We discuss these potential effects on efficiency, competition, and capital formation above. *See supra* section IV.C.

transaction, which may include margin or similar payments demanded by the fund's counterparty as a result of mark-to-market losses, or payments that the fund may make in order to exit the transaction. The proposed rule's requirement that the fund maintain qualifying coverage assets with a value equal to the fund's risk-based coverage amount is designed to require the fund to have qualifying coverage assets to cover future losses and any resulting future payment obligations.[591] These aspects of the proposed rule's asset segregation requirements for derivatives transactions are consistent with suggestions of many commenters on the Concept Release, including a commenter that observed that requiring funds to segregate a mark-to-market amount under the contract as well as an additional amount meant to cover future losses "is more akin to the way portfolio managers and risk officers assess the portfolio risks created through the use of derivatives."[592]

By requiring a fund to determine its risk-based coverage amounts in accordance with board-approved policies and procedures, the proposed rule's approach to asset segregation is designed to provide a flexible framework that would allow funds to apply the requirements of the proposed rule to particular derivatives transactions used by funds at this time as well as those that may be developed in the future as financial instruments and investment strategies change over time.

In addition, the proposed asset segregation requirements may benefit investors by eliminating the existing practice by some funds (under existing staff guidance) to segregate for certain derivatives transactions (*e.g.*, derivatives that permit physical settlement), the notional

591 In addition, the asset segregation requirement in the proposed rule would limit a fund's derivatives exposure to the extent that the fund limits its derivatives usage in order to comply with the asset segregation requirements. *See supra* note 323 and accompanying text.

592 *See* ICI Concept Release Comment Letter.

amount. As we noted above, the notional amount of a derivatives transaction does not necessarily equal, and often will exceed, the amount of cash or other assets that a fund ultimately would likely be required to pay or deliver under the derivatives transaction. Existing staff guidance contemplates that a fund will segregate assets equal to a derivative's full notional amount for certain derivatives and the derivative's daily mark-to-market liability for others. The proposed rule would benefit investors by requiring funds to evaluate their obligations under a derivatives transaction—including by considering future potential payment obligations represented by the derivative's risk-based coverage amount—rather than segregating assets equal to either a derivative's notional value or a mark-to-market liability based solely on the type of derivative involved, as under the current approach.

The proposed rule generally would require a fund to segregate cash and cash equivalents as qualifying coverage assets in respect of its coverage obligations for its derivatives transactions. To the extent that a fund currently posts collateral to counterparties for derivatives transactions,[593] the fund's mark-to-market coverage amount would be reduced by the value of the posted assets that represent variation margin, and the fund's risk-based coverage amount would be reduced by the value of the posted assets that represent initial margin, mitigating the need for the fund to segregate additional cash and cash equivalents. We believe that cash equivalents are an appropriate component of qualifying coverage assets for derivatives transactions because these securities usually settle within one day[594] and do not generally fluctuate in value with market conditions.[595] Therefore, cash and cash equivalents are readily available to support

593 *See, e.g.*, ISDA Margin Survey 2015, *supra* note 370.

594 *See, e.g.*, http://www.sec.gov/answers/tplus3.htm.

595 This is in contrast to funds' segregating any liquid asset under existing staff guidance, which may increase the likelihood that a fund's segregated assets decline in value at the same time the fund

derivatives positions should the need for additional funding arise at short notice, for example due to margin calls, without a fund having to unwind such positions.[596] The immediacy of funding needs for derivatives transactions may mean that other types of assets commonly used for short-term needs (such as meeting fund redemption requests which can take three days to settle when redeemed through a broker-dealer[597]) would be insufficiently liquid to meet the fund's obligations under a derivatives contract. Furthermore, we understand that cash and cash equivalents are commonly used for posting collateral or margin for derivatives transactions.[598]

For all of these reasons, we believe that the proposed asset segregation requirements should more effectively result in a fund having sufficient assets to meet its obligations under its derivatives transactions. By requiring the fund to maintain qualifying coverage assets—generally cash equivalents—sufficient to cover the fund's current mark-to-market obligation and an additional amount designed to address future losses, the proposed rule is designed to reduce the risk that the fund would be required to sell portfolio assets in order to generate assets to satisfy the fund's derivatives payment obligations, particularly in an environment where those assets may have experienced a temporary decline in value, thereby magnifying the fund's losses on the forced sale. In addition to the benefit to investors, as discussed above, counterparties to the derivatives transactions may benefit from an increased expectation of repayment given the higher quality of assets that are set aside for the funds' performance of their contractual

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experiences losses on the derivatives transaction.

596 We recognize that requiring funds generally to maintain cash and cash equivalents may have other associated effects. We discuss these potential effects above in section IV.C.

597 Open-end funds that are redeemed through broker-dealers must meet redemption requests within three business days because broker-dealers are subject to rule 15c6-1 under the Securities Exchange Act of 1934. *See* Liquidity Release, *supra* note 5, at n.21.

598 See the discussion of the ISDA margin Survey 2015 in footnote 370.

obligations. The proposed asset segregation requirements may also provide a number of additional positive effects on efficiency, competition, and capital formation as discussed above in section IV.C.

c. Quantified Costs

As with the quantified costs we discuss above regarding the exposure-based and risk-based portfolio limits (section III.B.1), we expect that funds would incur one-time and ongoing operational costs to establish and implement systems in order to comply with the proposed asset segregation requirements. As discussed above, and pursuant to existing Commission statements and staff guidance, two general practices have developed: the notional amount segregation approach and the mark-to-market segregation approach. Also as discussed above, funds today are determining their current mark-to-market losses, if any, each business day with respect to the derivatives for which they currently segregate assets on a mark-to-market basis, and funds also already calculate their liability under derivatives transactions on a daily basis for various other purposes, including to satisfy variation margin requirements and to determine the fund's NAV. We believe that funds that currently calculate their liability under their derivatives transactions on a daily basis would likely calculate the proposed mark-to-market coverage amount in the same manner, and therefore would not likely incur significant new costs when calculating the fund's mark-to-market coverage amount under the proposed rule.[599]

The risk-based coverage amount would be determined in accordance with policies and procedures approved by the fund's board that are required to take into account certain factors

599 *See supra* section III.C.1.a (noting that funds already calculate their liability under derivatives transactions on a daily basis for other purposes, including to satisfy variation margin requirements, and to determine the fund's NAV). We discuss below in section IV.D.5, the estimated costs for the proposed asset segregation requirements for a fund that enters solely into financial commitment transactions.

specified in the proposed rule. By requiring funds to establish appropriate policies and procedures, rather than prescribing specific segregation amounts or methodologies, the proposed rule is designed to allow funds to assess and determine risk-based coverage amounts based on their specific derivatives transactions, investment strategies and associated risks. As a result, we expect that, for funds that are significant users of derivatives, these funds may already use VaR or other risk-management tools to manage associated risks, and may be able to reduce costs by using these tools to calculate the risk-based coverage amount. We therefore anticipate that the relative costs to a particular fund are likely to vary, depending on the extent to which a fund enters into derivatives transactions and the level of sophistication of a fund's risk management processes surrounding its use of derivatives. These costs will directly impact funds (and may indirectly impact fund investors if a fund's adviser incurs costs and passes along its costs to investors through increased fees).

Our staff estimates that the one-time operational costs necessary to establish and implement the proposed asset segregation requirements would range from $25,000 to $75,000[600] per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund. These estimated costs are attributable to the following activities: (i) developing and implementing policies and procedures to comply with the proposed rule's requirement that, at least once each business day, the fund maintains the required qualifying coverage assets in respect of its derivatives transactions; (ii) planning, coding, testing, and installing any system modifications relating to the asset segregation requirements; and (iii) preparing training materials and administering training sessions for staff in affected areas.

As we discussed above, a fund that is part of a fund complex would likely benefit from

600 *See supra* note 570.

economies of scale and incur costs closer to the low-end of the estimated range of costs, while a standalone fund is more likely to incur costs closer to the higher-end of the estimated range of costs. Our staff also estimates that a standalone fund that is a light or moderate user of derivatives may choose to comply with the proposed rule by implementing a less automated system, and thus be more likely to incur costs closer to the low-end of the estimated range of costs. We anticipate that if there is demand to develop systems and tools related to the asset segregation requirements, market participants (or other third parties) may develop programs and applications that a fund could purchase at a cost likely less than our estimated cost to develop the programs and applications internally.

Staff also estimates that each fund would incur ongoing costs related to implementing the asset segregation requirements under proposed rule 18f-4. Staff estimates that such costs would range from 65% to 75% of the one-time costs discussed above.[601] Thus, staff estimates that a fund would incur ongoing annual costs associated with the asset segregation requirements that would range from \$16,250 to \$56,250.[602] These costs are attributable to the following activities: (i) at least once each business day, the fund verifies that it maintains the required qualifying coverage assets in respect of its derivatives transactions; (ii) systems maintenance; and (iii) additional staff training.

As discussed above in section IV.D.1, in the DERA staff analysis, 68% of all of the

601 In estimating the total quantified costs of our proposed rule, we estimate that the asset segregation requirements (as compared with the portfolio limitation requirements) would likely impose ongoing costs that are proportionately larger than initial costs (*e.g.*, because of the need to determine and identify qualifying coverage assets each business day). Accordingly, and based on staff experience and outreach, we estimate that these ongoing costs would range from 65% to 75% of the initial costs. *See supra* notes 570 and 574.

602 This estimate is based on the following calculations: 0.65 x \$25,000 = \$16,250; 0.75 x \$75,000 = \$56,250.

sampled funds did not have any exposure to derivatives transactions. These funds thus do not appear to use derivatives transactions or, if they do use them, do not appear to do so to a material extent. Staff estimates that the remaining 32% of funds (3,831 funds[603]) would seek to rely on the proposed rule, and therefore comply with the rule's asset segregation requirements. As with the other quantified costs we discuss in this Release, we believe that many funds belong to a fund complex and are likely to experience economies of scale. We therefore expect that the lower-end of the estimated range of costs ($25,000 in one-time costs; $16,250 in annual costs) better reflects the total costs likely to be incurred by many funds.

The proposed asset segregation requirements may also impose indirect costs, such as the potential reduction in fund returns that could result if funds are required to segregate cash and cash equivalents, rather than potentially higher-yielding liquid assets (such as equities, as permitted under existing staff guidance). We are unable to quantify this cost because we do not have sufficient data with respect to the nature and extent to which funds segregate assets under existing staff guidance, or sufficient data to determine the amount of the reduction in return under the proposed rule. However, because the proposed rule would permit a fund to reduce its mark-to-market and risk-based coverage amounts by the value of assets that represent variation margin and initial margin, respectively, such costs are likely mitigated. In this regard we note that this treatment does not only apply to cash and cash equivalents, but extends to any asset considered satisfactory as collateral by a counterparty. Therefore, funds retain the flexibility to optimize their collateral management and post their most cost-efficient collateral, subject to limitations that counterparties or other regulatory requirements may impose on the quality of

603 This estimate is based on the following calculation: 11,973 funds x 32% = 3,831 funds. *See supra* note 578.

acceptable collateral.[604] We also do not know if, or the extent to which, funds might instead shift to investments other than derivatives transactions (or financial commitment transactions) that would not be subject to the proposed rule, including the rule's asset segregation requirements. Finally, we do not know the specific manner in which funds' policies and procedures would provide for the determination of risk-based coverage amounts, and thus do not know the amount funds would segregate under the proposed rule to cover the risk-based coverage amounts. For these reasons, we are unable to quantify the impact of these potential indirect costs.

#### *4. Risk Management Program*

##### a. Requirements

As discussed above in section III.D, a fund that seeks to enter into derivatives transactions and rely on proposed rule 18f-4, except with respect to funds that engage in only a limited amount of derivatives transactions and that do not enter into certain complex derivatives transactions, would be required to establish a formalized derivatives risk management program, including the appointment of a derivatives risk manager.

##### b. Benefits

The proposed derivatives risk management program is designed to complement the proposed rule's portfolio limitations and asset segregation requirements by requiring that a fund subject to the requirement assess and manage the particular risks presented by the fund's use of derivatives. The derivatives risk management program would not apply, however, to funds that make only limited use of derivatives and do not use complex derivatives because we expect that the risks and potential impact of these funds' derivatives transactions may not be as significant in

[604] For example, as discussed above, ISDA reported in a 2015 survey that cash represented 77% of collateral received for uncleared derivatives transactions (with government securities representing an additional 13% percent), while for cleared OTC transactions with clients, cash represented 59% of initial margin received (with government securities representing an additional 39%) and 100% of variation margin received. *See supra* note 370.

comparison to the risks of the funds' overall investment portfolios and may be appropriately addressed by the proposed rule's other requirements, including the requirement to determine risk-based coverage amounts. The proposed rule, therefore, provides a tailored approach that we expect would benefit funds and investors by requiring funds that use derivatives more substantially to establish derivatives risk management programs while allowing certain funds to continue using derivatives (as deemed appropriate by a fund) to help implement the fund's strategy without first having to establish a derivatives risk management program under the proposed rule, provided such use is limited.[605]

The proposed derivatives risk management program requirement aims to promote a minimum baseline in the fund industry with regard to the use of derivatives transactions, and should improve funds' management of the risks related to a fund's use of derivatives as well as the awareness of, and oversight by, the fund's board (through the proposed rule's derivatives risk manager's reporting). In this regard we recognize that the benefits a particular fund and its investors would enjoy and the costs that it would incur in establishing a derivatives risk management program would vary depending on the particular fund's current practices. We believe that the proposed rule's promotion of a standardized level of risk management in the fund industry, however, would promote investor protection by elevating the overall quality of derivatives risk management across the fund industry. Improved quality of risk management related to funds' use of derivatives, may, for example, reduce the possibility of fund losses attributable to leverage and other risks related to the use of derivatives.

Investors should have increased confidence, for example, that a fund that states that it

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605 A fund that limits its derivatives exposure to no greater than 50% of the value of the fund's net assets, and that does not use "complex derivatives transactions," would not be required to adopt and implement a derivatives risk management program. *See* rule 18f-4(a)(3).

uses derivatives as part of achieving its investment strategy does so in ways that comply with regulatory requirements, and are consistent with the fund's own stated investment objectives, policies, and risk profile. Monitoring of the risks related to derivatives may also help protect investors from losses stemming from derivatives. To the extent that the derivatives risk management program results in more robust monitoring of the risks related to derivatives (including leverage risks that may magnify losses resulting from negative market movements), the derivatives risk management program may reduce the risk of a fund suffering unexpected losses. This, in turn, may reduce adverse repercussions for other market participants, including fund counterparties, and reduce the risk of potential forced sales which can create or exacerbate stress on other market participants. We also expect that the derivatives risk management program (including its recordkeeping requirements) should also improve the ability of the Commission, through its examination program, to evaluate the risks incurred by funds with respect to their derivatives transactions and how funds manage those risks.

c. Quantified Costs

In addition to the costs discussed above regarding the exposure-based and risk-based portfolio limitations and asset segregation requirements, certain funds would also incur one-time costs to establish and implement a derivatives risk management program in compliance with proposed rule 18f-4, as well as ongoing program-related costs. As discussed above, funds today employ a range of different practices, with varying levels of comprehensiveness and sophistication, for managing the risks associated with their use of derivatives. Certain elements of the derivatives risk management program may entail variability in related compliance costs, depending on a fund's particular circumstances, including the fund's investment strategy, and nature and type of derivatives transactions used by a fund.

As discussed in section II.D, we understand that the advisers to many funds whose investment strategies entail the use of derivatives already assess and manage the risks associated with their derivatives transactions. Funds whose current practices closely align with the proposed derivatives risk management program would incur relatively lower costs to comply with proposed rule 18f-4. Funds whose practices regarding derivatives risk management are less comprehensive or not closely aligned with the risk management requirements in the proposed rule, on the other hand, may incur relatively higher initial compliance costs. The nature and extent of a fund's use of derivatives also may affect the level of costs (and benefits) that the fund would incur. A fund that uses derivatives more extensively may incur relatively greater costs in in establishing a risk management program reasonably designed to assess and manage the risk associated with the fund's derivatives, particularly if the fund engages in complex derivatives transactions. A fund that engages in derivatives to a lesser extent, or that uses fewer complex derivatives transactions, may incur lower costs. In any case, the costs associated with a fund's risk management program would directly impact funds (and may indirectly impact fund investors if a fund's adviser incurs costs and passes along its costs to investors through increased fees).

Our staff estimates that the one-time costs necessary to establish and implement a derivatives risk management program would range from \$65,000 to \$500,000[606] per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund. These estimated costs are attributable to the following activities: (i) developing policies and procedures relating to each of the required program elements and

[606] *See supra* note 570. We note that some funds, and in particular smaller funds for example, may not have appropriate existing personnel capable of fulfilling the responsibilities of the proposed derivatives risk manager, or may choose to hire a new employee to act as the derivatives risk manager rather than assigning that responsibility to a current employee or officer of the fund or the fund's investment adviser who is not a portfolio manager. We would expect that a fund that is required to hire a new derivatives risk manager would likely incur costs on the higher end of our estimated range of costs.

administration of the program (including the designation of a derivatives risk manager); (ii) integrating and implementing the policies and procedures described above; and (iii) preparing training materials and administering training sessions for staff in affected areas.

Staff estimates that each fund would incur ongoing program-related costs, as a result of proposed rule 18f-4, that range from 65% to 75% of the one-time costs necessary to establish and implement a derivatives risk management program.[607] Thus, staff estimates that a fund would incur ongoing annual costs associated with proposed rule 18f-4 that would range from $42,250 to $375,000.[608] These costs are attributable to the following activities: (i) assessing, monitoring, and managing the risks associated with the fund's derivatives transactions; (ii) reviewing and updating periodically any models (including VaR models), measurement tools, or policies and procedures that are a part of, or used in, the program to evaluate their effectiveness and reflect changes in risks over time; (iii) providing written reports to the fund's board, no less frequently than quarterly, describing the adequacy of the fund's program and the effectiveness of its implementation; and (iv) additional staff training.

Under the proposed rule, a fund that limits its derivatives exposure to 50% or less of net assets (and does not enter into complex derivatives transactions) would not be required to establish a derivatives risk management program.[609] In the DERA staff analysis, approximately

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607 In estimating the total quantified costs of our proposed rule, we estimate that the derivatives risk management program requirements, similar to the asset segregation requirements, would likely impose ongoing costs that are proportionately larger than initial costs. Accordingly, and based on staff experience and outreach, we estimate that these ongoing costs would range from 65% to 75% of the initial costs. *See supra* note 601.

608 This estimate is based on the following calculations: 0.65 x $65,000 = $42,250; 0.75 x $500,000 = $375,000.

609 A fund would be required to measure its aggregate exposure associated with its derivatives transactions immediately after entering into any senior securities transaction. *See* rule 18f-4(a)(3)(i). Funds that use complex derivatives transactions, as defined in the proposed rule, also

10% of all sampled funds had aggregate exposure from derivatives transactions exceeding 50% of net assets.[610] An additional approximately 4% of the funds in DERA's sample had aggregate exposure from derivatives of between 25-50% of net assets.[611] In light of this, Commission staff estimates that approximately 14% of funds (1,676 funds[612]) would establish a derivatives risk management program. As with the other quantified costs we discuss in this Release, we believe that many funds belong to a fund complex and are likely to experience economies of scale. We therefore expect that the lower-end of the estimated range of costs ($65,000 in one-time costs; $42,250 in annual costs) better reflects the total costs likely to be incurred by many funds.

5. *Financial Commitment Transactions*

a. Requirements

As discussed above in section III.E, the proposed rule would require a fund that enters into financial commitment transactions in reliance on the rule to maintain qualifying coverage assets, identified on the books and records of the fund and determined at least once each business day, with a value equal to the fund's aggregate financial commitment obligations, which generally are the amounts of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under its financial commitment transactions. The proposed rule

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would be required to establish risk management programs, even if the funds' derivatives exposure was less than 50% of net assets. The proposed rule's definition of complex derivatives transactions is based on whether the amount payable by either party to a derivatives transaction is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction, or is a non-linear function of the value of the underlying reference asset, other than due to the optionality arising from a single strike price. *See* rules 18f-4(a)(4)(ii); 18f-4(c)(1).

610 *See* DERA White Paper, *supra* note 73, Figure 11.1. DERA staff was unable to determine the extent to which funds use derivatives transactions that would be complex derivatives transactions, based on the data available to the staff. The staff is thus unable to estimate the number of funds that would be required to have a risk management program solely as a result of their use of complex derivatives transactions. *See supra* note 609.

611 *See* DERA White Paper, *supra* note 73, Figure 11.1.

612 This estimate is based on the following calculation: 11,973 funds x 14% = 1,676 funds. *See supra* note 578.

would permit a fund to maintain as qualifying assets for a financial commitment transaction assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board of directors.

b. Benefits

By requiring the fund to maintain qualifying coverage assets to cover the fund's full potential obligation under its financial commitment transactions, the proposed rule generally would take the same approach to these transactions that we applied in Release 10666, with some modifications (primarily to the types of segregated assets that would be permitted under the proposed rule). The proposed rule would limit a fund's obligations under financial commitment transactions, in that the fund could not incur obligations under those transactions in excess of the fund's qualifying coverage assets. This would limit a fund's ability to incur obligations under financial commitment transactions to 100% of the fund's net assets, as discussed above in section III.E. As noted above, funds that enter into financial commitment transactions today in reliance on Release 10666 also do not incur obligations in excess of net assets,[613] and no fund in the DERA sample had greater than 100% aggregate exposure resulting from financial commitment transactions (the current economic baseline for such transactions).[614] As discussed above in section IV.C, we expect that proposed rule 18f-4 would permit a fund that enters solely into financial commitment transactions to operate much in the same way as it does today.

613 *See supra* note 93 and accompanying text.

614 DERA White Paper, *supra* note 73, Table 6.

### c. Quantified Costs

We estimate above in section IV.D.3 the potential costs of the asset segregation requirement for funds that enter into derivatives transactions. We estimated that the potential costs would include: (i) developing and implementing policies and procedures to comply with the proposed rule's requirement that the fund maintains the required qualifying coverage assets, identified on the books and records of the fund and determined at least once each business day; (ii) planning, coding, testing, and installing any system modifications relating to the asset segregation requirements; and (iii) preparing training materials and administering training sessions for staff in affected areas. A fund that enters solely into financial commitment transactions would similarly have an asset segregation requirement.

Although, as discussed above in section III.E, the amount and nature of "qualifying coverage assets" required differ with regard to derivatives transactions and financial commitment transactions, we believe that the operational costs to implement the asset segregation requirements would be the same. For both derivatives transactions and financial commitment transactions, funds would be required to establish policies and procedures regarding qualifying coverage assets, and in both cases funds would be required to assess their obligations under the transactions. For financial commitment transactions, a fund would be required to maintain assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay its financial commitment obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board of directors. For derivatives transactions, funds would be required to determine, in addition to a mark-to-market coverage amount, the transaction's risk-based coverage amount, which would represent an estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions, determined in accordance with policies and procedures approved by the fund's board. Although the required assessments would differ for derivatives transactions and financial commitment transactions, we expect that there would be no material difference in the activities involved (*e.g.*, developing and implementing policies and procedures, and modifying systems, to comply with the proposed rule's requirement that the fund maintains the required qualifying coverage assets), and thus no material difference in the associated costs.

Accordingly, we estimate that the one-time operational costs necessary to establish and implement the proposed asset segregation requirements would range from $25,000 to $75,000 per fund.[615] Staff also estimates that each fund would incur ongoing costs related to implementing the asset segregation requirements under proposed rule 18f-4. Staff estimates that such costs would range from 65% to 75% of the one-time costs discussed above.[616] Thus, staff estimates that a fund would incur ongoing annual costs associated with the asset segregation requirements that would range from $16,250 to $56,250.[617] In the DERA staff analysis, approximately 3% of all sampled funds entered into at least some financial commitment transactions, but had no exposure from derivatives transactions.[618] Staff estimates, therefore, that 3% of funds (359 funds[619]) would comply with the asset segregation requirements in proposed rule 18f-4 (applicable to financial commitment transactions). The above estimate of affected funds does not include money market

615 *See supra* note 600.

616 *See supra* note 601.

617 This estimate is based on the following calculations: 0.65 x $25,000 = $16,250; 0.75 x $75,000 = $56,250.

618 We address a fund that invests in both derivatives transactions and financial commitment transactions in section IV.D.3.

619 This estimate is based on the following calculation: 11,973 funds x 3% = 359 funds. *See supra* note 578.

funds or BDCs. We understand, however, that both money market funds and BDCS may engage in certain types of financial commitment transactions.[620] Therefore, we estimate that 537 money market funds and 88 BDCs would also comply with the asset segregation requirements in proposed rule 18f-4 (applicable to financial commitment transactions).[621] As with the other quantified costs we discuss in this Release, we believe that many funds belong to a fund complex and are likely to experience economies of scale. We therefore expect that the lower-end of the estimated range of costs ($25,000 in one-time costs; $16,250 in annual costs) better reflects the total costs likely to be incurred by many funds.

#### 6. *Amendments to Form N-PORT to Report Risk Metrics by Funds That are Required to Implement a Derivatives Risk Management Program*

##### a. Requirements

As discussed above in section III.G.2, proposed Form N-PORT would require funds that are required to implement a derivatives risk management program to disclose vega and gamma, risk metrics information that is not currently required by the Commission. As we previously stated, we believe that requiring certain funds to report vega and gamma would assist the Commission in better assessing the risk in a fund's portfolio. In consideration of the burdens of reporting selected risk metrics to the Commission and the benefits of more complete disclosure of a fund's risks, we are proposing to limit the reporting of vega and gamma to only those funds that are required to implement a derivatives risk management program.

The current set of requirements under which registered management investment companies (other than money market funds and SBICs) and ETFs organized as UITs publicly report complete portfolio investment information to the Commission on a quarterly basis, as well

620 *See supra* note 578.

621 *See supra* note 512 and accompanying text.

as the current practice of some investment companies to voluntarily disclose portfolio investment information, is the baseline from which we will discuss the economic effects of vega and gamma disclosure. The baseline is the same baseline from which we discussed the economic effects of Form N-PORT in the Investment Company Reporting Modernization Release.[622]

b. Benefits

The benefits of requiring certain funds to report vega and gamma on Form N-PORT are largely the same benefits as those identified in the Investment Company Reporting Modernization Release.[623] As discussed in that release, the information we would receive on Form N-PORT would facilitate the oversight of funds and would assist the Commission to better effectuate its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. For example, as we discussed in the Release, risk sensitivity measures improve the ability of Commission staff to efficiently analyze information for funds (such as a fund's exposure to changes in price and volatility) and identify funds with certain risk exposures that appear to be outliers among peer funds. Moreover, the information we would receive on Form N-PORT would improve the Commission's ability to analyze fund industry trends, monitor funds, and, as appropriate, engage in further inquiry or timely outreach in case of a market or other event. In particular, requiring certain funds to report vega and gamma on Form N-PORT could improve the Commission's ability to analyze funds' exposures to volatility and to their exposures to more sizable changes in the value of a derivative's reference security. These measures could be used in considering whether additional guidance or policy measures may be appropriate. The calculation of position-level risk-measures for some derivatives, including

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622 *See* Investment Company Reporting Modernization Release, *supra* note 138, at section IV.B.a.

623 *See* Investment Company Reporting Modernization Release, *supra* note 138, at section IV.B.b.

derivatives with unique or complicated payoff structures, sometimes requires time-intensive computation methods or additional information that Form N-PORT as proposed, would not require. In addition, the calculation of a second-order derivative, such as gamma, can be more computationally intensive than the calculation of a first-order derivative, such as delta and may require additional modelling. As discussed in section III. G. above, we believe that many of the funds that would be required to implement a derivatives risk management program already calculate risk measures such as gamma and vega as part of their portfolio management programs or have gamma and vega calculated for them by a service provider. Accordingly, we believe that requiring funds to calculate second-order derivatives, such as gamma, and provide risk measures for derivatives, such as vega, at the position-level, would improve the ability of staff to efficiently identify risk exposures of funds regardless of the types of derivatives.

The benefits of requiring certain funds to report vega and gamma on Form N-PORT would also benefit investors, to the extent that they use the information, to better differentiate investment companies based on their investment strategies. In general, we expect that institutional investors and other market participants would directly use the information from Form N-PORT more so than individual investors. Individual investors, however, could indirectly benefit from the information in Form N-PORT to the extent that third-party information providers and other interested parties are able to report on the information and other entities utilize the information to help investors make more informed investment decisions. An increase in the ability of investors to differentiate investment companies would allow investors to efficiently allocate capital across reporting funds more in line with their risk preferences, increase the competition among funds for investor capital, and could promote capital formation.

c. Costs

As we discussed in the Investment Company Reporting Modernization Release, to the extent that risk metrics are not currently contained in fund accounting or financial reporting systems, funds would bear one-time costs to update systems to adhere to the new filing requirements.[624] The one-time costs would depend on the extent to which investment companies currently report the information required to be disclosed. The one-time costs would also depend on whether an investment company would need to implement new systems, such as to calculate and report vega and gamma, and to integrate information maintained in separate internal systems or by third parties to comply with the new requirements. Based on staff outreach to funds, we believe that, at a minimum, funds would incur systems or licensing costs to obtain a software solution or to retain a service provider in order to report data on risk metrics, as risk metrics are not currently required to be reported on fund financial statements. Our experience with and outreach to funds indicates that the types of systems funds use for warehousing and aggregating data, including data on risk metrics, vary widely.

Similar to our proposal in the Investment Company Modernization Release,[625] the proposed amendments to proposed Form N-PORT relating to vega and gamma would increase the amount and availability of public information about certain investment companies' portfolio positions and investment strategy and could potentially harm fund shareholders by expanding the opportunities for professional traders to exploit this information by engaging in predatory trading practices, such as "front-running," and "copycatting/reverse engineering of trading strategies."[626]

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624 *See* Investment Company Reporting Modernization Release, *supra* note 138, at section IV.B.c.

625 *See* Investment Company Reporting Modernization Release, *supra* note 138, at section II.A.4; *see also* Liquidity Release, *supra* note 5.

626 *See* Investment Company Reporting Modernization Release, *supra* note 138, at n.170 and

These practices can reduce the returns of shareholders who invest in actively managed funds.[627] These practices can also reduce fund profitability from developing new investment strategies, and therefore negatively affect innovation and impact competition in the fund industry.

As with our proposed liquidity disclosures, we cannot currently predict the extent to which the proposed enhancements to funds' disclosures on Form N-PORT relating to risk metrics would give rise to front-running, predatory trading, and other activities that could be detrimental to a fund and its investors, and thus we are unable to quantify potential costs related to these activities. The costs that relate to the additional risk-sensitivity measures are also intertwined with the overall costs to funds and market participants that could result from the increased disclosure of currently non-public information associated with Form N-PORT in its entirety.[628] For example, any analyses of the risk metric-related disclosure proposed to be required could be affected by the enhanced reporting of any other additional information that could more clearly reveal the investment strategy of reporting funds.

The potential costs associated with the increased disclosure of currently non-public information on Form N-PORT are discussed in detail in our recent proposal to modernize investment company reporting,[629] as well as our recent proposal regarding liquidity risk-management programs.[630] These proposals also discuss the ways in which we have endeavored to mitigate these costs, including by proposing to maintain the status quo for the frequency and

accompanying and following text.

627 *See* Russ Wermers, *The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance*, 7 INVESTMENT COMPANY INSTITUTE PERSPECTIVE No. 3 (June 2001), *available at* http://www.ici.org/pdf/per07-03.pdf.

628 *See id.*, at paragraphs accompanying nn.663-673.

629 *See id.*

630 *See* Liquidity Release, *supra* note 5.

timing of disclosure of publicly available portfolio information.[631] While proposed Form N-PORT would be required to be filed monthly, it would be required to be disclosed quarterly and would not be made public until 60 days after the close of the period at issue. Because funds are currently required to disclose their portfolio investments quarterly (and this disclosure is made public with a 60-day lag), we believe that maintaining the status quo with regard to the frequency and the time lag of publicly available portfolio reporting would permit the Commission (as well as the fund industry generally) to assess the impact of the Form N-PORT filing requirements on the mix of information available to the public, and the extent to which these changes might affect the potential for predatory trading, before determining whether more frequent or more timely public disclosure would be beneficial to investors in funds.[632]

d. Quantified Costs

As further discussed below[633] and in our Investment Company Modernization Release,[634] we estimate that funds would incur certain annual costs associated with preparing, reviewing, and filing reports on Form N-PORT. The proposed amendments to proposed Form N-PORT would require funds that are required to implement a derivatives risk management program to report on Form N-PORT the vega and gamma for certain investments.[635] We estimate that 1,676

631 *See id.*, at section II.A.4 and paragraph accompanying n. 670.

632 *See id.*

633 *See infra* section V.

634 *See* Investment Company Reporting Modernization Release, *supra* note 138, at nn.658-662 accompanying text.

635 While we do not have a specific estimate of the number of funds that calculate gamma and vega, based on our discussions with members of the industry and due to the nature of those funds' investment strategies, we-expect that many of those funds currently calculate vega and gamma for its investment programs or have vega and gamma calculated for them by a service provider. However, we realize that it is possible that some funds may not calculate vega and gamma and our cost estimates reflect those costs as well.

funds[636] would be required to file, on a monthly basis, additional information on Form N-PORT as a result of the proposed amendments.[637] Assuming that 35% of funds (587 funds) would choose to license a software solution to file reports on Form N-PORT in house,[638] we estimate an upper bound on the initial annual costs to file the additional information associated with the proposed amendments for funds choosing this option of $3,352 per fund[639] with annual ongoing costs of $2,991 per fund.[640] We further assume that 65% of funds (1,089 funds) would choose to retain a third-party service provider to provide data aggregation and validation services as part of the preparation and filing of reports on Form N-PORT,[641] and we estimate an upper bound on the initial costs to file the additional information associated with the proposed amendments for funds choosing this option of $2,319 per fund[642] with annual ongoing costs of $1,517 per fund.[643]

### 7. *Amendments to Form N-CEN to Report Reliance on Proposed Rule 18f-4*

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636 Commission staff estimates, therefore, that approximately 14% of funds (1,676 funds) would be required to establish a derivatives risk management program. *See supra* note 612 and accompanying text.

637 There were 8,734 open-end funds (excluding money market funds, and including ETFs) as of the end of 2014. *See* Investment Company Institute, 2015 INVESTMENT COMPANY FACT BOOK (2015), *available at* https://www.ici.org/pdf/2015_factbook.pdf, at 177, 184.

638 This assumption tracks the assumption made in the Investment Company Reporting Modernization Release that 35% of funds would choose to license a software solution to file reports on Form N-PORT. *See* Investment Company Reporting Modernization Release, *supra* note 138, at nn.658-659 and accompanying text.

639 *See infra* note 797 and accompanying text.

640 *See infra* note 797.

641 This assumption tracks the assumptions made in the Investment Company Reporting Modernization Release that 65% of funds would choose to retain a third-party service provider to provide data aggregation and validation services as part of the preparation and filing of reports on Form N-PORT. *See* Investment Company Reporting Modernization Release, *supra* note 138, at nn.660-661 and accompanying text.

642 *See infra* note 803 and accompanying text.

643 *See infra* note 804 and accompanying text.

a. Requirements

As discussed above in section III.G.3, our amendments to proposed Form N-CEN would require funds to identify the portfolio limitation(s) on which a fund relied during the reporting period. As we stated above, this information would allow the Commission and others to monitor reliance on the exemptions under proposed rule 18f-4.

The current set of requirements—management companies must file reports on Form N-SAR semi-annually[644]—is the baseline from which we discuss the economic effects of Form N-CEN. The parties that could be affected by the rescission of Form N-SAR and the introduction of Form N-CEN include funds that currently file reports on Form N-SAR and funds that would file reports on Form N-CEN; the Commission; and, other current and future users of fund census information including investors, third-party information providers, and other interested potential users. The baseline is the same baseline from which we discussed the economic effects of Form N-CEN in the Investment Company Reporting Modernization Release.[645]

b. Benefits

The benefits of requiring funds to report reliance on certain exemptive rules, including proposed rule 18f-4, on Form N-CEN are largely the same benefits as those identified in the Investment Company Reporting Modernization Release.[646] As we discussed in that release, proposed Form N-CEN would improve the quality and utility of the information reported to the Commission and allow Commission staff to better understand industry trends, inform policy, and assist with the Commission's examination program. Similarly, identifying the portfolio limitation(s) on which a fund relied during the reporting period would identify for the staff funds

644 *See* rule 30b1-1.

645 *See* Investment Company Reporting Modernization Release, *supra* note 138, at section IV.E.a.

646 *See* Investment Company Reporting Modernization Release, *supra* note 138, at section IV.E.b.

that rely on proposed rule 18f-4. As discussed in our recent proposal to modernize Investment Company reporting, the information we would receive on Form N-CEN would facilitate the oversight of funds and would assist the Commission to better effectuate its mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.[647]

c. Costs

As we discussed above, to the extent that reliance on certain exemptive rules is not currently contained in fund accounting or financial reporting systems, funds would bear one-time costs to update systems to adhere to the new filing requirements.[648] The one-time costs would depend on the extent to which funds currently report the information required to be disclosed. The one-time costs would also depend on whether a fund would need to implement new systems in order to integrate information maintained in separate internal systems with the new requirements.

d. Quantified Costs

As further discussed below[649] and in our Investment Company Modernization Release,[650] we estimate that funds would incur certain annual costs associated with preparing, reviewing, and filing reports on Form N-CEN. The proposed amendments to proposed Form N CEN would require funds to identify the portfolio limitation(s) on which they relied during the reporting period.

In the Investment Company Modernization Reporting Release, the staff estimated that the Commission would receive an average of 3,146 reports per year, based on the number of existing

647 *See id.*

648 *See* Investment Company Reporting Modernization Release, *supra* note 138, at section IV.B.c.

649 *See infra* section V.B.6.

650 *See* Investment Company Reporting Modernization Release, *supra* note 138, at nn.658-662 accompanying text.

Form N-SAR filers, including 2,419 funds.[651] We further estimated that management investment companies would require 33.35 annual burden hours in the first year[652] and 13.35 annual burden hours in each subsequent year for preparing and filing reports on proposed Form N-CEN. We estimated that all Form N-CEN filers would have an aggregate annual expense of $12,395,064 for reports on Form N-CEN.[653]

As part of this burden, funds would be required to identify if they relied upon ten different rules under the Act.[654] While the costs associated with collecting and documenting the requirements under proposed rule 18f-4 are discussed above,[655] we believe that there are additional costs relating to identifying the portfolio limitation(s) on which a fund relied on proposed Form N-CEN. We therefore estimate that 2,419 funds would incur an average annual hour burden of .25 hours for the first year to compile (including review of the information), tag, and electronically file the additional information in light of the proposed amendments, and an average annual hour burden of approximately .1 hours for each subsequent year's filing. We

651 This estimate is based on 2,419 management companies and 727 UITs filing reports on Form N-SAR as of Dec. 31, 2014. UITs would not be required to complete Item 31 of proposed Form N-CEN. *See* General Instruction A of proposed Form N-CEN.

652 This estimate is based on the following calculation: 13.35 hours for filings + 20 additional hours for the first filing = 33.35 hours.

653 This estimate is based on annual ongoing burden hour estimate of 32,294 burden hours for management companies (2,419 management companies x 13.35 hours per filing) plus 6,623 burden hours for UITs (727 UITs x 9.11 burden hours per filing), for a total estimate of 38,917 burden ongoing hours. This was then multiplied by a blended hourly wage of $318.50 per hour, $303 per hour for Senior Programmers and $334 per hour for compliance attorneys, as we believe these employees would commonly be responsible for completing reports on proposed Form N-CEN ($318.50 x 38,917 = $12,395,064.50). *See* Investment Company Reporting Modernization Release, *supra* note 138, at n.723 and accompanying text.

654 *See* Item 31 of Proposed Form N-CEN.

655 *See supra* Sections IV.D.1. and IV.D.2.

further estimate an upper bound on the initial costs to funds of $80 per fund[656] with annual ongoing costs of $32 per fund.[657] We do not anticipate any change to the total external annual costs of $1,748,637.[658]

### E. Reasonable Alternatives

In formulating our proposal, we have considered various alternatives to the individual elements of proposed rule 18f-4. Those alternatives are outlined above in the sections discussing the proposed rule elements, and we have requested comment on these alternatives.[659] The following discussion addresses significant alternatives to proposed rule 18f-4, which involve broader issues than the more granular alternatives to the individual rule elements discussed above in section III of this Release. First, we discuss an alternative approach focused on asset segregation. This approach would allow funds to establish their own minimum asset segregation requirements for derivatives transactions while taking into account a variety of risk measures, but would not include additional limitations designed to impose a limit on leverage. Second, we discuss an approach that would require a fund engaging in derivatives transactions to segregate liquid assets equal in value to the full amount of the potential obligations under the derivatives transactions. This approach would, in effect, apply the approach in Release 10666 to all types of derivatives. Third, we discuss the European Union provisions relating to UCITS funds and alternative investment funds ("AIFs")[660] as an alternative approach to our proposed rule. Fourth, we discuss whether it would be a reasonable alternative to rely on enhancing derivatives-related

656 *See infra* note 815.

657 *See infra* note 816.

658 *See infra* note 821.

659 *See supra* sections III.B-III.F.

660 AIFs are alternative investment funds that are marketed to professional investors in the European Union.

disclosure. In addition to these discussions regarding alternatives to proposed rule 18f-4, we also discuss below certain alternatives to our proposed amendments to Proposed Form N-PORT.

### 1. *Mark-to-Market Plus "Cushion Amount" Alternative*

In the Concept Release we discussed an alternative approach to funds' current asset segregation approaches—generally, notional amount and mark-to-market segregation as discussed above—that was originally proposed in the 2010 ABA Derivatives Report. This alternative approach would allow individual funds to establish their own asset segregation standards for derivatives transactions but would not impose any additional requirements or overall limits on a fund's use of derivatives. Under this alternative, a fund would be required to adopt policies and procedures that would include, among other things, minimum asset segregation requirements for each type of derivatives instrument, taking into account relevant factors such as the type of derivative, the specific transaction, and the nature of the assets segregated ("Risk Adjusted Segregation Amounts"). In developing these standards, fund investment advisers might take into account a variety of risk measures, including VaR and other quantitative measures of portfolio risk, and would not be limited to the notional amount or mark-to-market standards.[661] This alternative is similar in some ways to the proposed rule's asset coverage requirements for derivatives transactions, as discussed in section IV.D.3. The proposed rule differs from this alternative in that it imposes requirements in addition to those related to asset coverage, including overall notional amount limits and the requirement for certain funds to have derivatives risk management programs.

[661] The 2010 ABA Derivatives Report recommended that these minimum Risk Adjusted Segregated Amounts be reflected in policies and procedures that would be subject to approval by the fund's board of directors and disclosed (including the principles underlying the Risk Adjusted Segregated Amounts for different types of derivatives) in the fund's SAI.

Certain commenters on the Concept Release suggested that segregation of a fund's daily mark-to-market liability alone may not be effective in at least some cases, and suggested that we impose asset segregation requirements under which a fund would include in its segregated account for a derivative an amount designed to address future losses (a "cushion amount") in addition to the daily mark-to-market liability for the derivative.[662] Some commenters specifically supported the 2010 ABA Derivatives Report alternative that used Risk Adjusted Segregated Amounts and many commenters generally supported using a "principles-based approach" to asset segregation[663] that would permit funds to adopt policies and procedures that would include minimum asset segregation requirements for each type of derivatives instrument, taking into account relevant factors.[664] Some commenters expressed the view that the optimal amount of cover for many derivatives may be somewhere in between the full notional and mark-to-market amounts and that the amount should be expected to cover the potential loss to the fund.[665] One of these commenters recommended that fund boards should be responsible for designing asset segregation policies with the objective of maintaining segregated assets sufficient to meet

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662 *See*, *e.g.*, SIFMA Concept Release Comment Letter; ICI Concept Release Comment Letter.

663 *See*, *e.g.*, BlackRock Concept Release Comment Letter; Invesco Concept Release Comment Letter; Loomis Concept Release Comment Letter; ICI Concept Release Comment Letter; IDC Concept Release Comment Letter; ABA Concept Release Comment Letter; Comment Letter of Stradley Ronon Stevens & Young LLP (Nov. 7, 2011) (File No. S7-33-11), *available at* http://www.sec.gov/comments/s7-33-11/s73311-27.pdf; MFDF Concept Release Comment Letter; T. Rowe Concept Release Comment Letter; Vanguard Concept Release Comment Letter; AlphaSimplex Concept Release Comment Letter; Oppenheimer Concept Release Comment Letter; Rafferty Concept Release Comment Letter.

664 *See*, *e.g.*, ABA Concept Release Comment Letter; IDC Concept Release Comment Letter; BlackRock Concept Release Comment Letter; Invesco Concept Release Comment Letter; ICI Concept Release Comment Letter; MFDF Concept Release Comment Letter; AlphaSimplex Concept Release Comment Letter; Loomis Concept Release Comment Letter; T. Rowe Price Concept Release Comment Letter; Comment Letter of Security Investors, LLC (Nov. 7, 2011) (File No. S7-33-11), *available at* http://www.sec.gov/comments/s7-33-11/s73311-36.pdf.

665 *See*, *e.g.*, ICI Concept Release Comment Letter; Invesco Concept Release Comment Letter.

obligations arising from the fund's derivatives under "extreme but plausible market conditions."[666] Another commenter argued that the cushion amount generally should be equal to the initial margin that funds will generally be required to post for derivatives following the implementation of margin requirements under the Dodd-Frank Act or, in the alternative, a cushion amount determined by funds based on a portfolio-wide analysis of their derivatives transactions.[667] This commenter suggested that initial margin represents an amount designed to protect against potential future losses, and where regulators or clearinghouses have determined the amount of initial margin that must be posted, they have already made determinations about the level of risk represented by an instrument.[668]

As discussed above in section IV.D.3, the rule we are proposing today would require a fund that enters into derivatives transactions and financial commitment transactions in reliance on the proposed rule to maintain an appropriate amount of qualifying coverage assets. For derivatives transactions, a fund would be required to maintain qualifying coverage assets with a value equal to at least the sum of the fund's aggregate mark-to-market coverage amounts and risk-based coverage amounts.[669] For financial commitment transactions, a fund would be

666 ICI Concept Release Comment Letter (noting that "*extreme but plausible market conditions*" is a statutory standard used by swap execution facilities and derivatives clearing organizations to determine the minimum amount of financial resources such entities must have to ensure, with a reasonably high degree of certainty, that they will be able to satisfy their obligations. *See*, *e.g.*, section 5b(c)(2) of the Commodity Exchange Act, as amended by section 725(c) of the Dodd-Frank Act.).

667 *See* SIFMA Concept Release Comment Letter. *See* section III.C. for a discussion of why we are not proposing to use initial margin to determine asset segregation amounts.

668 *See* SIFMA Concept Release Comment Letter.

669 Proposed rule 18f-4(a)(2). *See also* proposed rule 18-f(4)(c)(6) (definition of mark-to-market coverage amount) and 18-f(4)(c)(9) (definition of risk-based coverage amount).

required to maintain qualifying coverage assets with a value equal to at least the fund's aggregate financial commitment obligations.[670]

The proposed rule's asset segregation requirement would in many ways be consistent with the approaches recommended by the 2010 ABA Derivatives Report and by commenters in that it would require funds to maintain amounts intended to cover the fund's current mark-to-market amount to cover the amount that would be payable by the fund if the fund were to exit the derivatives transaction at such time, plus an additional amount that represents a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions.

However, the proposed rule would differ significantly from the approach recommended in the 2010 ABA Derivatives Report and by some commenters in that the proposed rule would impose portfolio limitations, as discussed in section III.B.1.c, designed to impose a limit on the amount of leverage a fund may obtain through derivatives and other senior securities transactions. The 2010 ABA Derivatives Report alternative, in contrast, focused on asset segregation without any other limitation on a fund's use of senior securities transactions. The proposed rule's inclusion of both portfolio limitations and asset coverage requirements would be consistent with the recommendation of one commenter, which supported a principles-based approach to asset segregation but also recognized that we might "wish to consider adopting an overall leverage limit that funds would be required to comply with, notwithstanding that they have segregated liquid assets to back their obligations."[671]

[670] Proposed rule 18f-4(b). *See also* proposed rule 18f-4(c)(5) (definition of financial commitment obligation).

[671] *See* Vanguard Concept Release Comment Letter, at n.18.

The 2010 ABA Derivatives Report also recommended an asset segregation approach that would give discretion to boards to determine the segregation amount for each instrument and thus the amount of derivatives exposures that the fund could obtain. The proposed asset coverage requirements, by contrast, would be based in part on procedures approved by the fund's board, but would also impose specific requirements on the fund's asset coverage practices, including by generally requiring the fund to segregate short-term, highly liquid assets.

As noted in section III.A, we believe that the proposed rule's approach for derivatives transactions—providing separate portfolio limitations and asset segregation requirements—would be more effective than an approach focusing on asset segregation alone, particularly when it is coupled with a risk management program for funds that engage in more than a limited amount of derivatives transactions or that use certain complex derivatives transactions, as we are proposing today. Moreover, the approach recommended in the 2010 ABA Derivatives Report and similar suggestions by some commenters would provide discretion to funds to determine their derivatives-related requirements, and as a result, the extent of their use of senior securities transactions. We believe that this alternative approach under the 2010 ABA Derivatives Report, without more, may not result in a meaningful limitation on funds' use of derivatives, and thus would not address the undue speculation concern expressed in section 1(b)(7) or the asset sufficiency concern expressed in section 1(b)(8), as discussed above in section II. We believe that relying solely on the discretion of funds and their boards of directors for limitations on the use of derivatives would not be a sufficient basis for an exemption from section 18, which imposes a limit on the extent to which funds may issue senior securities.

### 2. *Applying Notional Amount Segregation to All Senior Securities Transactions*

Another alternative approach we considered was to apply the approach in Release 10666 to all types of derivatives, thereby requiring that a fund engaging in any derivatives transaction segregate liquid assets of the types we specified in Release 10666 equal in value to the full amount of the conditional and unconditional obligations incurred by the fund (also referred to as notional amount segregation).[672]

Although the approach in Release 10666 appears to have addressed the concerns reflected in sections 1(b)(7) and 1(b)(8) for the trading practices described in that release, applying it to derivatives by requiring funds to segregate the types of liquid assets we described in Release 10666 equal in value to the full notional amount of each derivative may require funds to hold more liquid assets than may be necessary to address the purposes and concerns underlying section 18, as discussed above in section III.A. Furthermore, as discussed above in section III.B.1.c., given the contingent nature of funds' derivatives obligations and the various ways in which funds use derivatives—both for investment purposes to increase returns but also to mitigate risks—we believe it is appropriate to provide funds some additional flexibility to use derivatives, subject to the limitations set forth in the proposed rule.

### 3. *UCITS Alternative*

In developing proposed rule 18f-4, we considered the current guidelines that apply to UCITS funds. As discussed below, while our proposed rule is similar in some respects to the guidelines that cover UCITS funds, our proposed rule also differs in other respects. We also

672 *See supra* note 54 and accompanying text.

considered the current guidelines that apply to AIFs. We discuss further below how our proposed rule generally differs from the guidelines that govern AIFs.

The Committee of European Securities Regulators ("CESR") (which, as of January 1, 2011, became the European Securities and Markets Authority, or "ESMA"), conducted an extensive review and consultation concerning exposure measures for derivatives used by UCITS funds. CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS ("Global Exposure Guidelines")[673] were issued in 2010, and addressed the implementation of the European Commission's 2009 revised UCITS Directive ("2009 Directive").[674] Under the 2009 Directive, UCITS funds are permitted to engage in any type of derivatives investments subject to compliance with one of two permissible, alternative methods to limit their exposure to derivatives: (i) the "commitment" approach and (ii) the VaR approach.[675]

673 *See* CESR Global Guidelines, *supra* note 162. In order for CESR's Global Exposure Guidelines to be binding and operational in a particular EU Member State, the Member State must adopt them. To date, it appears that a few EU Member States, *e.g.*, Ireland and Luxembourg, have adopted them. The majority of UCITS funds, however, are domiciled in either Ireland or Luxembourg.

674 *See* Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations, and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) ("Directive 2009/65/EC"), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF.

675 *See* CESR Global Guidelines, *supra* note 162. The CESR's Global Exposure Guidelines note that the "use of a commitment approach or VaR approach or any other methodology to calculate global exposure does not exempt UCITS from the requirement to establish appropriate internal risk management measures and limits." *Id.*, at 5. In addition, with respect to the selection of the methodology used to measure global exposure, CESR's Global Exposure Guidelines note that the "commitment approach should not be applied to UCITS using, to a large extent and in a systematic way, financial derivative instruments as part of complex investment strategies." *Id.*, at 6.

Under the commitment approach, a UCITS fund's net exposures from derivatives may not exceed 100% of the fund's net asset value.[676] CESR's Global Exposure Guidelines extensively address the calculation of derivatives exposure and specify a method for calculating derivatives exposure that generally uses the market value of the equivalent position in the underlying asset.[677] CESR's Global Exposure Guidelines also incorporate a schedule of derivative investments and their corresponding conversion methods to be used in calculating global exposure.[678] The applicable conversion method for UCITS funds depends on the particular derivative.[679] We believe that the calculation of derivatives exposure under CESR's Global Exposure Guidelines is generally similar to the method of calculating notional amounts, which under our proposed rule would be included in a fund's calculation of its exposure. Instead of specifying in the rule the precise method of determining notional amounts for every particular

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676 Directive 2009/65/EC, *supra* note 674 at Article 51(3) at 62 ("The exposure is calculated taking into account the current value of the underlying assets, the counterparty risk, future market movements and the time available to liquidate the positions"). *See also* CESR Global Guidelines, *supra* note 162 ("The commitment conversion methodology for standard derivatives is always the market value of the equivalent position in the underlying asset. This may be replaced by the notional value or the price of the futures contract where this is more conservative. For non-standard derivatives, where it is not possible to convert the derivative into the market value or notional value of the equivalent underlying asset, an alternative approach may be used provided that the total amount of the derivatives represent a negligible portion of the UCITS portfolio.").

677 The market value of the underlying reference asset may be "replaced by the notional value or the price of the futures contract where this is more conservative." *See* CESR Global Guidelines, *supra* note 162, at 7.

678 *See id.*, at 7-12.

679 *Id.*, at 8. For example, for bond futures, the applicable conversion method is the number of contracts multiplied by the notional contract size multiplied by the market price of the cheapest-to-deliver reference bond. For plain vanilla fixed/floating interest rate and inflation swaps, the applicable conversion method is the market value of the underlier (though the notional value of the fixed leg may also be applied). *Id.* For foreign exchange forwards, the prescribed conversion method is the notional value of the currency leg(s). *Id.*, at 9. With respect to non-standard derivatives, where it is not possible to convert the derivative into the market value or notional value of the equivalent underlying asset, CESR's Global Exposure Guidelines note that "an alternative approach may be used provided that the total amount of the derivatives represent a negligible portion of the UCITS portfolio." *Id.*, at 7.

type of derivative transaction, we have proposed a definition of notional amount that we believe can be more readily adapted both to current and new types of derivatives transactions.

Although the CESR commitment approach is similar with respect to our proposed method of calculating derivatives exposure, the commitment approach differs from our proposed exposure-based alternative in several ways. First, the commitment approach permits exposures of up to only 100% of the fund's net assets rather than our proposed rule's exposure-based portfolio limit of 150%. Second, the commitment approach permits UCITS funds to reduce their calculated derivatives exposure for certain netting and hedging transactions. With respect to netting, CESR's Global Exposure Guidelines allow netting of derivatives transactions regardless of the derivatives' due dates, provided that the trades are "concluded with the sole aim of eliminating the risks linked to the positions."[680] In addition, UCITS funds are permitted to reduce their exposures for hedging arrangements – these are described in CESR's Global Exposure Guidelines as transactions that do not necessarily refer to the same underlying asset but are entered into for the "sole aim of offsetting risks" linked to other positions.[681]

As discussed above in section III.B, given the flexibility provided by our proposed 150% exposure limit (and the requirements provided under our proposed risk-based portfolio limit discussed above), the proposed rule does not permit a fund to reduce its exposure for purposes of the rule's portfolio limitations for particular types of hedging, risk-mitigating or offsetting transactions. For all of the reasons discussed in that section, we believe that it would be more appropriate, in lieu of a reduction for hedging on a transaction-by-transaction basis, to provide

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680 *See* CESR Global Guidelines, *supra* note 162, at 13.

681 *See* CESR Global Guidelines, *supra* note 162, at 18. The UCITS requirements also permit the fund to reduce its exposures if the derivative directly swaps the performance of financial assets held by the fund for other reference assets or the derivative, in combination with cash held by the fund, represents the equivalent of a cash investment in the reference asset.

funds with the flexibility to enter into derivatives transactions for a variety of purposes, including those that are partially or primarily for hedging, through a 150% exposure limitation.

Similar to our proposed rule, the UCITS guidelines also provide an alternative risk-based approach. This alternate method for UCITS compliance is the VaR (or other advanced risk measurement) approach, designed to measure potential losses due to market risk rather than measure leverage exposures.[682] When following the VaR approach to calculate global exposure, a UCITS fund may use either an absolute VaR approach or a relative VaR approach.[683] The absolute VaR approach limits the maximum VaR that a UCITS fund can have relative to its net assets, and as a general matter, the absolute VaR is limited to 20 percent of the UCITS fund's net assets.[684] Under the relative VaR approach, the VaR of the portfolio cannot be greater than twice the VaR of an unleveraged reference portfolio.[685]

While our proposed rule also uses a VaR ratio comparison as a risk measurement method to limit the use of derivatives, we have determined not to propose the use of an absolute VaR method that would limit the fund's VaR amount to a specified percentage of net assets, or a relative VaR that would measure a fund's VaR as compared to a reference benchmark. As

682 *Id.*, at 22 ("More particularly, the VaR approach measures the maximum potential loss at a given confidence level (probability) over a specific time period under normal market conditions.").

683 *Id.*, at 23. A global exposure calculation using the VaR approach should consider all the positions in the UCITS' portfolio. *Id.*, at 22. The VaR approach measures the probability of risk of loss rather than the amount of leverage in portfolio and the VaR calculation is required to have a "one-tailed confidence interval of 99%," a holding period of one month (20 business days), an observation period of risk factors of at least one year (unless a shorter observation period is justified by a significant increase in price volatility), at least quarterly updates, and at least daily calculation. *Id.* at 26. UCITS employing the VaR approach are required to conduct a "rigorous, comprehensive and risk-adequate stress testing program." *Id.*, at 30-34.

684 *Id.*, at 25-26.

685 CESR's Global Exposure Guidelines note that the relative VaR approach does not directly measure leverage of the UCITS' strategies but instead allows the UCITS to double the risk of loss under a given VaR model as compared to a reference benchmark. *Id.*, at 24.

discussed above in the section III.B.2.b, our concern with respect to an absolute VaR method is that the calculation of VaR on a historical basis is highly dependent on the historical trading conditions during the measurement period and can change dramatically both from year to year and from periods of benign trading conditions to periods of stressed market conditions. As discussed above in section III.B.1.c, we believe that our exposure-based portfolio limit of 150% and our risk-based portfolio limit of 300% are appropriately designed to impose a limit on the amount of leverage a fund may obtain through certain derivatives and other senior securities transactions while also providing flexibility for funds to use derivatives transactions for a variety of purposes. However, a limitation based on an absolute VaR method could potentially allow a fund to obtain very substantial amounts of leveraged exposures that the fund could then be required to unwind during stressed market conditions, which could adversely affect the fund and its investors. In addition, our staff has noted that some UCITS funds relying on the absolute VaR method disclose gross notional amounts for their portfolios that are substantially in excess of our proposed portfolio limitations that we believe are appropriate for funds subject to section 18 of the Act as discussed above in section III.B.1.c.

The relative VaR method for UCITS funds, under which a fund would compare its total portfolio VaR to an unleveraged reference portfolio or benchmark, allows a UCITS fund to use derivatives in its portfolio so long as the VaR of the UCITS fund is not greater than two times the VaR of the reference portfolio or benchmark. As discussed above in section III.B.2.a, we have not proposed this particular approach for several reasons, including concerns regarding difficulties in determining whether a reference index or benchmark is itself leveraged. Our staff has also noted that a number of UCITS funds do not use the relative VaR method and many alternative funds use a benchmark that is a money market rate (such as LIBOR), oftentimes because an analogous investment benchmark is not available for the fund strategy, which suggests that a VaR comparison to a benchmark would not provide a suitable method for many fund strategies.[686]

In addition to the two alternative exposure limitations, CESR's Global Exposure Guidelines also subject UCITS funds to "cover rules" for investments in financial derivatives.[687] Under these cover rules, a UCITS fund should, at any given time, be capable of meeting all its payment and delivery obligations incurred by transactions involving financial derivative investments, and should monitor to make sure that financial derivatives transactions are adequately covered.[688] More specifically, in the case of a derivative that provides, automatically or at the counterparty's choice, for physical delivery of the underlying financial instrument, a UCITS fund: (i) should hold the underlying financial instrument in its portfolio as cover, or, (ii) if the UCITS fund deems the underlying financial instrument to be sufficiently liquid, it may hold as coverage other assets (including cash) as cover on the condition that these assets (after applying appropriate haircuts), held in sufficient quantities, may be used at any time to acquire the underlying financial instrument that is to be delivered.[689] In the case of a derivative that provides, automatically or at the UCITS fund's choice, for cash settlement, the UCITS fund should hold enough liquid assets after appropriate haircuts to allow the UCITS fund to make the contractually required payments.[690] Similar to the UCITS cover rules, the asset segregation

686 *See supra* notes 268-270 and accompanying text.

687 CESR Global Guidelines, *supra* note 162, at 40.

688 *Id.*

689 *Id.*

690 *Id.* On April 14, 2011, ESMA published a final report on the guidelines on risk measurement and the calculation of the global exposure for certain types of structured UCITS funds. *See*

requirements of our proposed rule are also designed to assure that a fund has sufficient assets to pay its derivatives related obligations. However, our proposed asset segregation requirements differ from the UCITS requirements for the reasons discussed above in section III.C.

ESMA has also more recently adopted guidelines to assess the leverage used by AIFs marketed to professional investors in the European Union.[691] These guidelines supplement a directive proposed by the European Commission, the Alternative Investment Fund Managers Directive ("AIFMD"), which had the objective to create a comprehensive and effective regulatory and supervisory framework for AIF managers at the European level.[692] AIFMD defines leverage as "any method by which the [AIF manager] increases the exposure of an AIF it manages whether through borrowing of cash or securities, or leverage embedded in derivative positions or by any other means."[693] For each AIF that it manages, the AIF manager is required to establish a maximum level of leverage which it may employ on behalf of the AIF and to report the AIF's leverage to investors and supervisory authorities.[694] Unlike the UCITS regime,

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*Guidelines to Competent Authorities and UCITS Management Companies on Risk Measurement and the Calculation of Global Exposure for Certain Types of Structured UCITS*, Final Report Ref.: ESMA/2011/112 (Apr. 14, 2011), *available at* http://www.esma.europa.eu/popup2.php?id=7542 (these guidelines, which will need to be adopted and implemented by Member States, propose for certain types of structured UCITS, an optional regime for the calculation of the global exposure).

691 *See* Commission Delegated Regulation (EU) No 231/2013 of Dec. 19, 2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision ("Commission Delegated Regulation No. 231/2013"), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0231 (providing for the calculation of leverage for alternative investment funds).

692 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 ("Directive 2011/61/EU"), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0061&from=EN.

693 *See* Directive 2011/61/EU, *supra* note 692, at Article 4(1)(v).

694 *See id.*, at Articles 15(4) and 7(3)(a).

AIFMD does not restrict the amount of leverage that may be used by an AIF; instead it requires managers to set their own limitation for each AIF. The requirements in AIFMD thus serve primarily to provide a consistent method of measuring and reporting of the amount of leverage used by AIFs.

AIF managers are required to calculate leverage used by AIFs both under a gross method and a commitment method. As described by ESMA, "[t]he gross method gives the overall exposure of the AIF whereas the commitment method gives insight in the hedging and netting techniques used by the manager."[695] The measurement of exposure relating to derivatives and borrowings in our proposed rule generally is similar to AIFMD requirements with respect to the measurement of the gross exposure relating to derivatives and borrowings.[696] The commitment method under AIFMD, however, allows an AIF also to report its exposure after reduction for netting and hedging arrangements. The determination of whether a set of transactions are eligible for netting or hedging treatment would be made by the AIF manager subject to general principles focusing on whether the transactions result in an "unquestionable reduction of the general market risk" or alternatively whether the transactions are part of an arbitrage strategy that is seeking to generate a return based on the relative performance of two correlated assets.[697]

695 *See* Commission Delegated Regulation No. 231/2013, *supra* note 691, at preamble paragraph (12).

696 The AIFMD requirements do allow for a reduction to account for cash equivalents held by the fund while requiring leverage from reinvestment of collateral held by the fund to be added to the leverage calculation.

697 For example, the AIF directive notes that a "portfolio management practice which aims to keep the alpha of a basket of shares (comprising a limited number of shares) by combining the investment in that basket of shares with a beta-adjusted short position on a future on a stock market index should not be considered as complying with the hedging criteria. Such a strategy does not aim to offset the significant risks linked to the investment in that basket of shares but to offset the beta (market risk) of that investment and keep the alpha. The alpha component of the basket of shares may dominate over the beta component and as such lead to losses at the level of

For reasons discussed above, we have decided not to propose a rule that would allow fund managers to set their own exposure limitation for each fund. In addition, as discussed above, we believe it would be difficult to develop standards for determining circumstances under which transactions are offsetting other transactions, and thus we have chosen not to incorporate a hedging reduction into the proposed exposure limitations. Accordingly, and as discussed above in section III.B.1.c, we believe that a test that focuses on the notional amounts of funds' derivatives transactions, coupled with an appropriate exposure limit, will better accommodate the broad diversity of registered funds and the ways in which they use derivatives. We also believe that, to the extent fund managers may wish to include more specific risk metrics with respect to their funds, they may do so by including such metrics within the proposed derivatives risk management program.

4. *Disclosure Alternative and Considerations*

We considered whether enhancements to funds' disclosure obligations with respect to a fund's use of derivatives would be a reasonable alternative to the proposed rule.[698] We received a range of comments on the Concept Release regarding the efficacy of disclosure. Some commenters that recommended disclosure enhancements also suggested approaches that went beyond enhanced disclosure,[699] and at least one commenter specifically argued that disclosure

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the AIF. For that reason, it should not be considered as a hedging arrangement." *See* Commission Delegated Regulation No. 231/2013, *supra* note 691, at preamble paragraph (23).

698 *See*, *e.g.*, Security Investors Comment Letter (arguing that significant changes to the current regulatory scheme are not warranted, but that the existing regulatory scheme could be improved upon the clarification of existing guidance, including greater disclosure about funds' investments in derivatives); Ropes and Gray Comment Letter (suggesting that absent any indication that funds are not making adequate disclosure with respect to derivatives, or that fund boards are not fulfilling their oversight responsibilities, there is no compelling reason for the Commission to impose new restrictions on the use of derivatives).

699 *See*, *e.g.*, ABA Concept Release Comment Letter; ICI Concept Release Comment Letter.

alone was not sufficient.[700] For example, this commenter noted that the financial crisis of 2007-2008 demonstrated that disclosure alone is not adequate because markets may do a poor job of regulating the use of leverage by financial institutions, thus allowing leverage to increase until there are catastrophic failures.[701] On the other hand, some commenters specifically argued that in at least certain circumstances the use of derivatives by a fund should be addressed solely through disclosure. For example, one commenter suggested that disclosure requirements would be suitable for transactions that possess only economic leverage, which the commenter argued would implicate the risks and volatility of a fund similar to that of other types of non-derivative investments.[702] Another commenter argued that leveraged funds, particularly leveraged exchange-traded funds, present fewer concerns than do other funds that use derivatives due in part to their robust level of disclosure, and should not have any additional derivatives limitations imposed on them.[703]

Although disclosure is an important mechanism through which funds inform existing and prospective shareholders of the fund's use of derivatives, we do not believe that an approach that focuses on disclosure would address the purposes and concerns underlying section 18 of the Act as effectively as the approach we are proposing today, particularly given that section 18 itself imposes a specific limitation on the amount of senior securities that may be issued by a fund regardless of the risk associated with the particular senior securities. In this regard we note that investment company abuse of leverage was a primary concern that led to enactment of the

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700 *See*, *e.g.*, Keen Concept Release Comment Letter.

701 *See* Keen Concept Release Comment Letter.

702 *See* ABA Concept Release Comment Letter. *See also* T. Rowe Price Concept Release Comment Letter; ICI Concept Release Comment Letter.

703 *See* Rafferty Concept Release Comment Letter.

Investment Company Act.[704] In the Investment Company Act's preamble, Congress cited excessive leverage as a major abuse that it meant to correct, declaring in section 1(b)(7) of the Act that the public interest and the interest of investors are adversely affected "when investment companies by excessive borrowing and the issuance of excess amounts of senior securities increase unduly the speculative character of their junior securities."[705] The proposed rule is designed to impose a limit on the amount of leverage a fund may obtain through derivatives and financial commitment transactions, whereas requiring enhancement to derivatives disclosure, absent additional requirements to limit leverage or potential leverage, would not appear to provide any limit on the amount of leverage a fund may obtain, and thus would not provide any regulatory distinction between funds regulated by the Act and private funds not regulated by the Act in respect of their respective ability to obtain leverage through derivatives. An approach focused on enhanced disclosure requirements thus does not appear to provide a sufficient basis for an exemption from the requirements of section 18 of the Act.

We do, however, believe that disclosure is an important aspect of the existing regulatory framework and that effective derivatives-related disclosure would complement the limitations on derivatives use in the proposed rule. Indeed, in May 2015, we proposed enhanced reporting and disclosure requirements for investment companies that include new reporting requirements for derivatives transactions, including, for most funds, more detailed reporting of the terms and

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704 In 1939, the Commission Released an exhaustive study of the investment company industry that laid the foundation for the Investment Company Act. SEC, Investment Trusts and Investment Companies, H.R. Doc. No. 707, 75th Cong., 3d Sess. pt. 1 (1939); SEC, Investment Trusts and Investment Companies, H.R. Doc. No. 70, 76th Cong., 1st Sess. pt. 2 (1939); SEC, Investment Trusts and Investment Companies, H.R. Doc. No. 279 Cong., 1st Sess. pt. 3 (1939). For a discussion of leveraged capital structures of investment companies, see Investment Trust Study pt.3, Ch. V, "Problems in Connection with Capital Structure," 1563-1940.

705 Section 1(b)(7) of the Investment Company Act.

conditions of each derivatives contract in a fund's portfolio on a monthly basis in a structured format.[706] The proposal also would require reporting of the fund's monthly net realized gain (or loss) and net change in unrealized appreciation (or depreciation) attributable to derivatives.[707]

As discussed in the Investment Company Reporting Modernization Release, these proposed requirements would, among other things, help the Commission and investors better understand the exposures that the derivatives create or hedge, which can be important to understanding a fund's investment strategy, use of leverage, and potential for risk of loss.[708] Such information would allow the Commission to better assess industry trends regarding the use of derivatives, which the Commission could use to better carry out its regulatory functions, such as the formulation of policy and guidance, the review of registration statements, and the examination of funds.[709] The Investment Company Reporting Modernization Release also included amendments to Regulation S-X that would require similar enhanced derivatives disclosures in fund financial statements, which would increase transparency of a fund's use of derivatives and comparability among funds to help investors better assess funds' use of derivatives and make more informed investment decisions.[710]

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706 Such information would be reported on proposed Form N-PORT. *See* Proposed Form N-PORT, Item C.11.; Investment Company Reporting Modernization Release, *supra* note 138. Our staff also has previously addressed funds' disclosure with respect to their use of derivatives in 2010 and 2013. *See Letter from Barry D. Miller, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission, to Karrie McMillan, General Counsel, Investment Company Institute* (July 30, 2010); SEC, *Disclosure and Compliance Matters for Investment Company Registrants That Invest in Commodity Interests*, IM Guidance Update (Aug. 2013) (No. 2013-05), *available at* https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-05.pdf.

707 Proposed Form N-PORT Item B.5.

708 *See* Investment Company Reporting Modernization Release, *supra* note 138, at Part II.A.2.d. and Part II.A.2.g.iv.

709 *See* Investment Company Reporting Modernization Release, *supra* note 138, at Part II.A.

710 *See* Investment Company Reporting Modernization Release, *supra* note 138, at Part II.C.

Amendments to Proposed Form N-PORT

The Commission is also proposing to require additional position level risk-sensitivity measures on Form N-PORT, vega and gamma, for funds that are required to implement a derivatives risk management program by proposed rule 18f-4(a)(3). These measures would improve the ability of Commission staff to efficiently understand and approximate the risk exposures of reporting funds.

A reasonable alternative is to require portfolio- and position-level risk-sensitivity measures in addition to vega and gamma that would provide Commission staff a more precise approximation of the risk exposures of reporting funds. For example, Form N-PORT could require the risk-sensitivity measures theta and rho at the position-level; and at the portfolio level measures that describe the sensitivity of a reporting fund to a 50 or 100 basis point change in interest rates and credit spreads or a measure of convexity. These measures could improve the ability of Commission staff to monitor the fund industry in connection with other risks and more sizable changes in prices and rates. While potentially valuable, requiring these additional measures could increase the burden on funds, and the additional precision might not significantly improve the ability of Commission staff to monitor the fund industry in most market environments. Another reasonable alternative is to not require any additional risk-sensitivity measures. Although the burden to investment companies to provide the information would be less if fewer or no risk-sensitivity measures were required by the Commission, we believe that the benefits from requiring the measures, including the ability to efficiently identify and size specific investment risks, justify the costs to investment companies to provide the measures.

Our proposal would require only those funds that are required to implement a derivatives risk management program to report vega and gamma on proposed Form N-PORT. As an alternative, we could require funds with lower exposures than those funds would be required to implement a derivatives risk management program to also report vega and gamma. Alternatively, we could redefine the basis for funds to implement a derivatives risk management program and therefore require a different set of funds to report the additional risk-sensitivity measures. However, as we discussed above, we believe that the current requirements will capture most of the funds that use derivatives as a significant factor of their returns, while not imposing burdens on funds that do not generally rely on derivatives as an important part of their investment strategies.[711]

### F. Request for Comment

The Commission requests comment on all aspects of this initial economic analysis, including whether the analysis has: (i) identified all benefits and costs, including all effects on efficiency, competition, and capital formation; (ii) given due consideration to each benefit and cost, including each effect on efficiency, competition, and capital formation; and (iii) identified and considered reasonable alternatives to the proposed new rule and rule amendments. We request and encourage any interested person to submit comments regarding the proposed rule, our analysis of the potential effects of the proposed rule and proposed amendments, and other matters that may have an effect on the proposed rule. We request that commenters identify sources of data and information as well as provide data and information to assist us in analyzing the economic consequences of the proposed rule and proposed amendments. We also are interested in comments on the qualitative benefits and costs we have identified and any benefits and costs we may have overlooked.

In addition to our general request for comment on the economic analysis associated with

711 *See supra* section III.G.2.

the proposed rule and proposed amendments, we request specific comment on certain aspects of the proposal:

- What factors, taking into account a fund's particular risks and circumstances, would cause particular variance in funds' compliance costs related to the proposed rule?
- We request comment on our estimates of the one-time and ongoing costs associated with proposed rule 18f-4, including the exposure-based and risk-based portfolio limits, asset segregation requirement, and risk management program requirement. Do commenters agree with our cost estimates? If not, how should our estimates be revised, and what changes, if any, should be made to the assumptions forming the basis for our estimates? Are there any significant costs that have not been identified within our estimates that warrant consideration? To what degree would economies of scale affect compliance costs for funds?
- We request comment on our estimate of the number of funds that would seek to comply with the exposure-based and risk-based portfolio limits, asset segregation requirements, and the derivatives risk management program requirement. Do commenters agree that a fund that belongs to a fund complex is likely to achieve economies of scale that make it more likely that a fund will incur costs closer to the low-end of the range of estimated costs?
- Do commenters agree with our belief that the benefits and costs associated with the asset segregation requirement for a fund that invests solely in financial commitment transactions would be the same as those we estimate for the asset segregation requirements that would apply to a fund that also enters into derivatives transactions? Why or why not?

- To what extent do commenters anticipate that proposed rule 18f-4 could lead funds to modify their investment strategies or decrease their use of derivatives?
- To what extent do funds' current practices regarding derivatives risk management, if applicable, currently align with the proposed derivatives risk management program, and what operational and other costs would funds incur in modifying their current practices to comply with the proposed requirements?

## V. PAPERWORK REDUCTION ACT

### A. Introduction

Proposed rule 18f-4 contains several "collections of information" within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[712] The proposed amendments to proposed Form N-PORT and Form N-CEN would impact the collections of information burdens associated with that proposed form described in the Investment Company Reporting Modernization Release.[713] In the Investment Company Reporting Modernization Release, we submitted new collections of information for proposed Form N-PORT and Form N-CEN.[714] The title for these new collections of information is "Form N-PORT under the Investment Company Act, Monthly Portfolio Investments Report" and "Form N-CEN Under the Investment Company Act, Annual Report for Registered Investment Companies." We are submitting new collections of information for proposed new rule 18f-4 under the Investment Company Act of 1940. The titles for this new collection of information would be: "Rule 18f-4 under the Investment Company Act of 1940, Use of Derivatives by Registered Investment Companies and Business Development Companies."

[712] 44 U.S.C. 3501 through 3521.

[713] *See* Investment Company Reporting Modernization Release, *supra* note 138, at section V.

[714] *See id.*

The Commission is submitting these collections of information to the OMB for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11. 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 Commission is proposing new rule 18f-4 and is proposing to amend proposed Form N-PORT and Form N-CEN. The new rule and proposed amendments are designed to address the investor protection purposes and concerns underlying section 18 of the Act and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions in light of the dramatic growth in the volume and complexity of the derivatives markets over the past two decades and the increased use of derivatives by certain funds. We discuss below the collection of information burdens associated with these reforms.[715]

## B. Proposed Rule 18f-4

Proposed rule 18f-4 would require a fund that relies on the rule in order to enter into derivatives transactions to: (i) comply with one of two alternative portfolio limitations designed to impose a limit on the amount of leverage the fund may obtain through derivatives transactions and other senior securities transactions; (ii) manage the risks associated with its derivatives transactions by maintaining an amount of certain assets, defined in the rule as "qualifying coverage assets," designed to enable the fund to meet its obligations under its derivatives transactions; and (iii) depending on the extent of its derivatives usage, establish a derivatives risk management program. A fund that relies on the proposed rule in order to enter into financial commitment transactions would be required to maintain qualifying coverage assets equal in

715 We discuss below these collection of information burdens on each fund, but note that certain of the estimated costs may be incurred instead, at least in part, by other third parties, including a fund's investment adviser.

value to the fund's full obligations under those transactions. As discussed in greater detail below, a number of the proposed requirements are collections of information under the PRA. The respondents to proposed rule 18f-4 would be certain registered open- and closed-end management investment companies and BDCs. Compliance with proposed rule 18f-4 would be mandatory for all funds that seek to engage in derivatives transactions and financial commitment transactions in reliance on the rule, which would otherwise be subject to the restrictions of section 18. No information would be submitted directly to the Commission under proposed rule 18f-4. To the extent that records required to be created and maintained by funds under the rule are provided to Commission staff in connection with examinations or investigations, such information would be kept confidential subject to the provisions of applicable law. We believe that our collection of information cost estimates below are an upper bound because, as discussed in section IV, many funds are part of a fund complex and will likely benefit from economies of scale.

### *1. Portfolio Limitations for Derivatives Transactions*

Proposed rule 18f-4 would require a fund that engages in derivatives transactions in reliance on the rule to comply with one of two alternative portfolio limitations.[716] Under the exposure-based portfolio limit, a fund generally would be required to determine that, immediately after entering into any senior securities transaction, its aggregate exposure does not exceed 150% of the value of the fund's net assets.[717] Under the risk-based portfolio limit, a fund generally would be required to determine that, immediately after entering into any senior securities transaction, (i) the fund's full portfolio VaR does not exceed its securities VaR and

[716] Proposed rule 18f-4(a)(1).

[717] Proposed rule 18f-4(a)(1)(i).

(ii) the fund's aggregate exposure does not exceed 300% of the value of the fund's net assets.[718] In addition, a fund that engages in derivatives transactions in reliance on the proposed rule would not be required to have a derivatives risk management program if the fund complies with a portfolio limitation under which, immediately after entering into any derivatives transaction, the fund's aggregate exposure does not exceed 50% of the value of the fund's net assets and the fund does not use complex derivatives transactions.[719]

As discussed above in section IV.D.1 and IV.D.2, in the DERA staff analysis, 68% of all of the sampled funds did not have any exposure to derivatives transactions, and these funds thus do not appear to use derivatives transactions or, if they do use them, do not appear to do so to a material extent.[720] Staff thus estimates that the remaining 32% of funds (3,831 funds[721]) will seek to rely on this part of proposed rule 18f-4, and therefore comply with the portfolio limitation requirements. These funds would be subject to the collections of information described below with respect to their applicable portfolio limitations.

Initial Determination of Portfolio Limitations

The proposed rule would require a fund's board of directors, including a majority of the directors who are not interested persons of the fund, to approve (a) the fund's determination to comply with either the exposure-based portfolio limit or the risk-based portfolio limit under the proposed rule, and (b) if applicable, the fund's determination to limit its aggregate exposure under derivatives transactions to not more than 50% of its NAV and not to use complex

718 Proposed rule 18f-4(a)(1)(ii).

719 Proposed rule 18f-4(a)(1).

720 None of the BDCs in the DERA sample had exposure to derivatives transactions.

721 This estimate is based on the following calculation: 11,973 funds x 32% = 3,831 funds. *See supra* note 578.

derivatives transactions.[722] We estimate a one-time burden of 3 hours per fund associated with a board's review and approval of a fund's portfolio limitation or, amortized over a three-year period, a burden of approximately 1 hour annually per fund. We therefore estimate that the total hourly burden for the initial reviews and approvals of funds' portfolio limitations would be 11,493 hours.[723] We estimate that each fund would incur a time cost of approximately $5,121 to obtain this initial approval, for a total initial time cost for all funds of approximately $19,618,551.[724] In addition to the internal costs described above, we also estimate that each fund would incur a one-time average external cost of $800 associated with a fund board consulting its outside legal counsel with regard to the required board approvals.[725]

Recordkeeping

The proposed rule would require a fund to maintain a record of each determination made by the fund's board that the fund will comply with one of the portfolio limitations under the proposed rule, which would include the fund's initial determination as well as a record of any

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722 Proposed rule 18f-4(a)(5)(i). The cost burdens associated with a fund board's approvals include costs incurred to prepare materials for the board's determinations, as well as the board's review and approval of determinations required by the proposed rule. *See infra* note 724.

723 This estimate is based on the following calculation: 3 hours x 3,831 funds = 11,493 hours.

724 This estimate is based on the following calculations: 0.6 hours x $301 (hourly rate for a senior portfolio manager) = $181; 0.6 hours x $455.5 (blended hourly rate for assistant general counsel ($426) and chief compliance officer ($485) = $273; 1.0 hours x $4,400 (hourly rate for a board of 8 directors) = $4,400; 0.8 hours (for a fund attorney's time to prepare materials for the board's determinations) x $334 (hourly rate for a compliance attorney) = $267. $181 + $273 + $4,400 + $267 = $5,121; $5,121 x 3,831 funds = $19,618,551. The hourly wages used are from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. The staff previously estimated in 2009 that the average cost of board of director time was $4,000 per hour for the board as a whole, based on information received from funds and their counsel. Adjusting for inflation, the staff estimates that the current average cost of board of director time is approximately $4,400.

725 This estimate is based on the following calculation: 2 hours x $400 (hourly rate for outside legal services) = $800.

determination made by the fund's board to change the portfolio limitation.[726] We estimate a one-time burden of 0.6 hours per fund associated with maintaining a record of a board's initial determination of the fund's portfolio limit or, amortized over a three-year period, a burden of about 0.2 hours annually per fund. We therefore estimate that the total burden for maintaining a record of a board's initial determination of the fund's portfolio limit would be 2,299 hours.[727] We also estimate that each fund would incur a time cost of approximately $38 to meet this requirement, for a total initial time cost of approximately $164,733.[728]

In addition, a fund that relies on the proposed rule also would be subject to an ongoing requirement to maintain a written record demonstrating that immediately after the fund entered into any senior securities transaction, the fund complied with its applicable portfolio limit, with such record reflecting the fund's aggregate exposure, the value of its net assets and, if applicable, the fund's full portfolio VaR and its securities VaR.[729] We estimate that each fund would incur an average burden of 50 hours to retain these records.[730] We therefore estimate that the total

726 Proposed rule 18f-4(a)(6)(i). The fund would be required to maintain this record for a period of not less than five years (the first two years in an easily accessible place) following each determination.

727 This estimate is based on the following calculation: 0.6 hours x 3,831 funds = 2,299 hours.

728 This estimate is based on the following calculation: 0.3 hours x $57 (hourly rate for a general clerk) = $17; 0.3 hours x $87 (hourly rate for a senior computer operator) = $26. $17 + $26 = $43; $43 x 3,831 funds = $164,733.

729 Proposed rule 18f-4(a)(6)(iv). The fund would be required to maintain this record for a period of not less than five years (the first two years in an easily accessible place) following each senior securities transaction. This written record requirement would also apply to a fund's monitoring of the 50% portfolio limit for purposes of the derivatives risk management program requirement (discussed below).

730 We assume for purposes of this estimate that funds would implement automated processes for creating a written record of their compliance with the applicable portfolio limit immediately after entering into any senior securities transaction, and that a fund would enter into at least one derivatives transaction or other senior securities transaction per trading day. Based on 250 trading days per year, and assuming 0.1 hours per trading day spent by a general clerk and 0.1 hours per trading day spent by a senior computer operator, we estimate the annual time cost to be

annual burden for maintaining these records would be 191,550 hours.[731] We also estimate that each fund would incur an annual time cost of approximately $3,600, and a total annual time cost for all funds of approximately $13,791,600.[732] We estimate that there are no external costs associated with this collection of information.[733]

Accordingly, we estimate that, for recordkeeping associated with a fund's portfolio limitations, including maintenance of a record of a board's initial determination of the fund's portfolio limit and maintenance of written records demonstrating the fund's ongoing compliance with applicable portfolio limits, the time burden per fund would be 50.6 hours and the time cost per fund would be $3,638.[734] We therefore estimate that the total burden for maintaining such records would be 193,849 hours, at an aggregate time cost of $13,937,178.[735]

Estimated Total Burden

Amortized over a three-year time period, the hour burdens and time costs for collections of information associated with portfolio limitations under proposed rule 18f-4, including the

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(0.1 x 250) = 25 hours per year per fund for each general clerk and senior computer operator.

731 This estimate is based on the following calculations: 50 hours x 3,831 funds = 191,550 hours.

732 This estimate is based on the following calculation: 25 hours x $57 (hourly rate for a general clerk) = $1,425; 25 hours x $87 (hourly rate for a senior computer operator) = $2,175. $1,425 + $2,175 = $3,600; $3,600 x 3,831 funds = $13,791,600.

733 Except as provided for above, we have estimated (both for purposes of the economic analysis and the PRA) the cost burdens associated with the proposed rule using a fund's internal resources, rather than third party solutions which may develop in the future. *See, e.g.*, *supra* text in paragraph following note 573.

734 This estimate is based on the following calculations: 0.6 hours (maintenance of a record of board's initial determination of fund's portfolio limit) + 50 hours (maintenance of written records demonstrating fund's compliance with applicable portfolio limits) = 50.6 hours; $38 (maintenance of a record of a board's initial determination of a fund's portfolio limit) + $3,600 (maintenance of written records demonstrating funds' compliance with applicable portfolio limits) = $3,638.

735 This estimate is based on the following calculations: 50.6 hours x 3,831 funds = 193,849 hours; $3,638 x 3,831 funds = $13,937,178.

burdens associated with (a) board review and approval of funds' initial portfolio limitations, (b) maintenance of records of initial board determinations of funds' portfolio limits, and (c) maintenance of written records demonstrating funds' compliance with applicable portfolio limits, are estimated to result in an aggregate average annual hour burden of 196,147 hours and aggregate time cost of $20,386,028.[736] In addition to the internal costs described above, we also estimate that each fund would incur a one-time average external cost of $800.

### 2. *Asset Segregation: Derivatives Transactions*

Proposed rule 18f-4 would require a fund that enters into derivatives transactions[737] in reliance on the rule to manage the risks associated with its derivatives transactions by maintaining an amount of specified assets (defined in the proposed rule as "qualifying coverage assets") designed to enable the fund to meet its obligations arising from such transactions.[738] A fund would be required to identify on the books and records of the fund, at least once each business day, qualifying coverage assets with a value equal to at least the fund's aggregate "mark-to-market coverage amounts" and "risk-based coverage amounts."[739] The mark-to-market coverage amount would mean the amount that would be payable by the fund, for each derivatives

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736 These estimates are based on the following calculations: (11,493 hours (year 1) + 2,299 hours (year 1) + (3 x 191,550 hours) (years 1, 2 and 3)) ÷ 3 = 196,147 hours; ($19,618,551 (year 1) + ($164,733 (year 1) + (3 x $13,791,600)) ÷ 3 = $20,386,028.

737 We include in this analysis a fund that enters into derivatives transactions, as well as financial commitment transactions and other senior securities. We discuss estimated PRA costs for a fund that enters solely into financial commitment transactions below.

738 Proposed rule 18f-4(a)(2), (c)(6), (c)(8), (c)(9).

739 Proposed rule 18f-4(a)(2). Qualifying coverage assets for derivatives transactions would generally mean cash and cash equivalents. The exceptions to the requirement to maintain cash and cash equivalents are for derivatives transactions under which a fund may satisfy its obligation by delivering a particular asset, in which case that particular asset would be a qualifying coverage asset. *See* proposed rule 18f-4(c)(8).

transaction, if the fund were to exit the derivatives transaction at the time of determination.[740] The risk-based coverage amount would mean the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions, determined in accordance with board-approved policies and procedures.[741] A fund would be permitted to adjust these coverage amounts, at its discretion, if the fund has entered into certain netting agreements, or the fund has posted variation margin (for the mark-to-market coverage amount) or initial margin (for the risk-based coverage amount), or collateral for such amounts payable by the fund.[742] A fund would be required to have policies and procedures approved by its board of directors (and maintained by the fund in an easily accessible place[743]) that are reasonably designed to provide for the fund's maintenance of qualifying coverage assets.[744]

As discussed above in section IV.D.3, DERA staff analysis shows that 68% of all sampled funds do not appear to use derivatives transactions (or if they do, do not appear to use them to a material extent). Staff estimates that the remaining 32% of funds (3,831 funds) and no BDCs will seek to rely on this aspect of proposed rule 18f-4, and therefore comply with the asset segregation requirements. These funds would be subject to the collections of information described below with respect to asset segregation requirements.

<u>Identification of Qualifying Coverage Assets</u>

740 Proposed rule 18f-4(c)(6).

741 Proposed rule 18f-4(c)(9).

742 Proposed rules 18f-4(c)(6)(i), (ii); 18f-4(c)(9)(i), (ii).

743 A fund must maintain a written copy of the fund's policies and procedures, approved by the fund's board, in effect, or at any time within the past five years were in effect, in an easily accessible place. Proposed rule 18f-4(a)(6)(ii).

744 Proposed rule 18f-4(a)(5)(ii).

The qualifying coverage assets requirement would subject funds to a collection of information insofar as they are required to make a daily identification on a fund's books and records of its maintenance of qualifying coverage assets, including determinations of the mark-to-market and risk-based coverage amounts. Although we expect that these activities would generally be automated and/or routine, our estimates below include estimates for anticipated time costs by a fund's staff to make manual adjustments to these determinations (*e.g.*, to reflect netting agreements, or account for assets posted as initial or variation margin or collateral). The cost estimates below also reflect the fact that, with regard to the mark-to-market coverage amount, we believe that funds already calculate their liability under derivatives transactions on a daily basis for various other purposes, including to satisfy variation margin requirements and to determine the fund's NAV. Funds also calculate their liability under derivatives transactions on a periodic basis in order to provide financial statements to investors. We generally expect that funds would be able to use these calculations to determine their mark-to-market coverage amounts.

We do not expect that this aspect of the proposed rule will impose any initial, one-time "collection of information" burdens on funds. We do estimate, however, that each fund would incur an average annual burden of 110 hours associated with the identification of qualifying coverage assets. We therefore estimate that the total annual burden for the identification of qualifying coverage assets would be 421,410 hours.[745] We also estimate that each fund would incur an annual time cost of approximately $11,530 to identify qualifying coverage assets, for a

[745] This estimate is based on the following calculation: 110 hours x 3,831 funds = 421,410 hours.

total annual time cost for all funds of approximately $44,171,430.[746] We estimate that there are no external costs associated with this collection of information.[747]

Board-Approved Policies & Procedures

Proposed rule 18f-4 would require funds to have written policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets. For purposes of this PRA analysis, we estimate that a fund would incur a one-time average burden of 15 hours associated with documenting its policies and procedures. The proposed rule would also require that the fund's board approve such policies and procedures and we estimate a one-time burden of 1 hour per fund associated with fund boards' review and approval of its policies and procedures. Amortized over a three-year period, this would be an annual burden per fund of approximately 5.3 hours. We estimate that the total one-time burden for the initial documentation, and board approval of, written policies and procedures to provide for a fund's maintenance of qualifying coverage assets would be 61,296 hours.[748] We also estimate that each fund would incur a time cost of approximately $6,291, and a total initial time cost for all funds of approximately $38,593,494.[749] We estimate that there are no ongoing annual costs associated with this collection of information. In addition to the internal costs described above, we also

746 This estimate is based on the following calculations: 100 hours x $87 (hourly rate for a senior computer operator) = $8,700; 10 hours x $283 (hourly rate for compliance manager) = $2,830. $8,700 + $2,830 = $11,530; $11,530 x 3,831 funds = $44,171,430.

747 *See supra* note 733.

748 This estimate is based on the following calculation: 16 hours x 3,831 funds = 61,296 hours.

749 This estimate is based on the following calculations: 7.5 hours x $301 (hourly rate for a senior portfolio manager) = $2,258; 7.5 hours x $455.5 (blended hourly rate for assistant general counsel ($426) and chief compliance officer ($485)) = $3,416; 1 hour x $4,400 (hourly rate for a board of 8 directors) = $4,400. $2,258 + $3,416 + $4,400= $10,074; $10,074 x 3,831 funds = $38,593,494.

estimate that each fund would incur a one-time average external cost of $800 associated with a fund board consulting its outside legal counsel with regard to the required board approvals.[750]

Recordkeeping

The proposed rule would require a fund to maintain a written copy of the policies and procedures approved by the fund's board of directors that are in effect, or at any time within the past five years were in effect, in an easily accessible place. We estimate a one-time burden (and no ongoing annual burden) of 1 hour per fund associated with maintaining a written copy of the fund's board-approved policies and procedures or, amortized over a three-year period, a burden of approximately 0.3 hours annually per fund. We therefore estimate that the total one-time burden for maintaining this record would be 3,831 hours.[751] We also estimate that each fund would incur a time cost of approximately $57, and a total initial time cost for all funds of approximately $218,367.[752] We estimate that there are no external costs associated with this collection of information.

In addition, a fund that relies on the proposed rule also would be subject to an ongoing requirement to maintain a written record reflecting the mark-to-market coverage amount and risk-based coverage amount for each derivatives transaction entered into by the fund and identifying the associated qualifying coverage assets, as determined by the fund at least once each business day, for a period of not less than five years (the first two years in an easily

[750] This estimate is based on the following calculation: 2 hours x $400 (hourly rate for outside legal services) = $800.

[751] This estimate is based on the following calculation: 1 hour x 3,831 funds = 3,831 hours.

[752] This estimate is based on the following calculation: 1 hour x $57 (hourly rate for a general clerk) = $57. $57 x 3,831 funds = $218,367.

accessible place).[753] We estimate that each fund would incur an average annual burden of 50 hours to retain these records.[754] We therefore estimate that the total annual burden for maintaining these records would be 191,550 hours.[755] We also estimate that each fund would incur an annual time cost of approximately $3,600, and a total annual time cost for all funds of approximately $13,791,600.[756] We estimate that there are no external costs associated with this collection of information.

Estimated Total Burden

Amortized over a three-year time period, the hour burdens and time costs for collections of information associated with the asset segregation requirement for derivatives transactions under proposed rule 18f-4, including the burdens associated with (a) identifying qualifying coverage assets; (b) documenting board-approved policies and procedures; and (c) maintaining required records, are estimated to result in an aggregate average annual hour burden of 634,669 hours and aggregate time costs of $70,900,317.[757] In addition to the internal costs described above, we also estimate that each fund would incur a one-time average external cost of $800.

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753 Proposed rule 18f-4(a)(6)(v).

754 We assume for purposes of this estimate that funds would implement automated processes for creating a written record of their compliance with the qualifying coverage asset requirements and that a fund would enter into at least one derivatives transaction per trading day. Based on 250 trading days per year, and assuming 0.1 hours per trading day spent by a general clerk and 0.1 hours per trading day spent by a senior computer operator, we estimate the annual time cost to be (0.1 x 250) = 25 hours per year per fund for each general clerk and senior computer operator.

755 This estimate is based on the following calculations: 50 hours x 3,831 funds = 191,550 hours.

756 This estimate is based on the following calculation: 25 hours x $57 (hourly rate for a general clerk) = $1,425; 25 hours x $87 (hourly rate for a senior computer operator) = $2,175. $1,425 + $2,175 = $3,600; $3,600 x 3,831 funds = $13,791,600.

757 These estimates are based on the following calculations: ((3 x 421,410 hours) (years 1, 2 and 3) + 61,296 (year 1) + 3,831 (year 1) + (3 x 191,550 hours) (years 1, 2 and 3)) ÷ 3 = 634,669 hours; ((3 x $44,171,430) + ($38,593,494 (year 1)) + ($218,367 (year 1)) + (3 x $13,791,600) (years 1, 2, and 3)) ÷ 3 = $70,900,317.

### 3. *Asset Segregation: Financial Commitment Transactions*

Proposed rule 18f-4 would require a fund that enters into financial commitment transactions in reliance on the rule to similarly maintain qualifying coverage assets designed to enable the fund to meet its obligations arising from such transactions. A fund would be required to identify on the books and records of the fund, at least once each business day, qualifying coverage assets with a value equal to at least the fund's aggregate financial commitment obligations.[758] Financial commitment obligations would mean the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction (as defined in the proposed rule).[759] A fund that enters solely into financial commitment transactions would, as described above for a fund that enters into derivatives transactions, be required to have policies and procedures approved by its board of directors (and maintained by the fund in an easily accessible place) that are reasonably designed to provide for the fund's maintenance of qualifying coverage assets.[760]

As discussed above in section IV.D.5, DERA staff analysis shows that approximately 3% of all sampled funds enter into at least some financial commitment transactions, but do not use derivatives transactions. Staff estimates, therefore, that 3% of funds (359 funds) would comply with the asset segregation requirements in proposed rule 18f-4 applicable to financial commitment transactions and would not also be complying with the asset segregation and other requirements applicable to derivatives transactions. In addition, staff estimates that 537 money market funds and 88 BDCs may engage in certain types of financial commitment transactions.

758 Proposed rule 18f-4(b)(1).

759 Proposed rule 18f-4(c)(5) (noting, that where the fund is conditionally or unconditionally obligated to deliver a particular asset, the financial commitment obligation shall be the value of the asset, determined at least once each business day).

760 Proposed rule 18f-4(b)(2)(3).

In sum, staff estimates that 984 funds would comply with the asset segregation requirements applicable to financial commitment transactions and incur the same costs we estimate above (with regard to funds that engage in derivatives transactions). These funds would be subject to the collections of information described below.

Identification of Qualifying Coverage Assets

Similar to the requirement applicable to a fund that enters into derivatives transactions (discussed above), a fund that enters solely into financial commitment transactions would, under the proposed rule, incur operational costs to establish and implement systems in order to comply with the proposed asset segregation requirements, including the proposed requirement that a fund maintain qualifying coverage assets, identified on the books and records of the fund, at least once each business day. We believe that the activities related to these requirements are largely the same, whether applicable to a fund that enters into derivatives transactions, or financial commitment transactions. Accordingly, we estimate the same costs to a fund that enters solely into financial commitment transactions as the asset segregation costs we estimate above for funds that enter into derivatives transactions.

We estimate that each fund would incur an average annual burden of 110 hours (and no initial one-time burdens) associated with the identification of qualifying coverage assets. We therefore estimate that the total annual burden for the identification of qualifying coverage assets would be 108,240 hours.[761] We also estimate that each fund would incur an ongoing annual time cost of approximately $11,530 to identify qualifying coverage assets, for a total ongoing annual

761 This estimate is based on the following calculation: 110 hours x 984 funds = 108,240 hours.

time cost for all funds of approximately $11,345,520.[762] We estimate that there are no external costs associated with this collection of information.

Board-Approved Policies & Procedures

A fund that enters solely into financial commitment transactions, like a fund that enters into derivatives transactions, would be required under the proposed rule to have board-approved policies and procedures regarding the maintenance of qualifying coverage assets. Accordingly, we estimate that a fund would incur a one-time average burden of 15 hours associated with documenting its policies and procedures. The proposed rule would also require that the fund's board approve such policies and procedures and we estimate a one-time burden of 1 hour per fund associated with fund boards' review and approval of its policies and procedures. Amortized over a three-year period, this would be an annual burden per fund of approximately 5.3 hours. We estimate that the total one-time burden for the initial documentation, and board approval of, written policies and procedures to provide for a fund's maintenance of qualifying coverage assets would be 15,744 hours.[763] We also estimate that each fund would incur a time cost of approximately $6,291, and a total initial time cost for all funds of approximately $9,912,816.[764] We estimate that there are no annual time costs associated with this collection of information. In addition to the internal costs described above, we also estimate that each fund would incur a one-

762 This estimate is based on the following calculations: 100 hours x $87 (hourly rate for a senior computer operator) = $8,700; 10 hours x $283 (hourly rate for compliance manager) = $2,830. $8,700 + $2,830 = $11,530; $11,530 x 984 funds = $11,345,520.

763 This estimate is based on the following calculation: 16 hours x 984 funds = 15,744 hours.

764 This estimate is based on the following calculations: 7.5 hours x $301 (hourly rate for a senior portfolio manager) = $2,258; 7.5 hours x $455.5 (blended hourly rate for assistant general counsel ($426) and chief compliance officer ($485)) = $3,416; 1 hour x $4,400 (hourly rate for a board of 8 directors) = $4,400. $2,258 + $3,416 + $4,400= $10,074; $10,074 x 984 funds = $9,912,816.

time average external cost of $800 associated with a fund board consulting its outside legal counsel with regard to the required board approvals.[765]

Recordkeeping

A fund that enters solely into financial commitment transactions would also be required under the proposed rule to retain a written copy of the fund's board-approved policies and procedures regarding the maintenance of qualifying coverage assets. This requirement also applies to funds that enter into derivatives transactions. Accordingly, as discussed above for the recordkeeping burdens associated with asset segregation for derivatives transactions, we estimate a one-time burden (and no annual burden) of 1 hour per fund associated with maintaining a written copy of the fund's board-approved policies and procedures or, amortized over a three-year period, a burden of approximately 0.3 hours annually per fund. We therefore estimate that the total one-time burden for maintaining this record would be 984 hours.[766] We also estimate that each fund would incur a time cost of approximately $57, and a total initial time cost for all funds of approximately $56,088.[767] We estimate that there are no external costs associated with this collection of information.

In addition, a fund that relies on the proposed rule also would be subject to an ongoing requirement to maintain a written record reflecting the amount of each financial commitment obligation associated with each financial commitment transaction entered into by the fund and identifying the associated qualifying coverage assets, as determined by the fund at least once

765 This estimate is based on the following calculation: 2 hours x $400 (hourly rate for outside legal services) = $800.

766 This estimate is based on the following calculation: 1 hour x 984 funds = 984 hours.

767 This estimate is based on the following calculation: 1 hour x $57 (hourly rate for a general clerk) = $57. $57 x 984 funds = $56,088.

each business day, for a period of not less than five years (the first two years in an easily accessible place).[768] We estimate that each fund would incur an average annual burden of 50 hours to retain these records.[769] We therefore estimate that the total annual hour burden for maintaining these records would be 49,200 hours.[770] We also estimate that each fund would incur an annual time cost of approximately $3,600, and a total annual time cost for all funds of approximately $3,542,400.[771] We estimate that there are no external costs associated with this collection of information.

Estimated Total Burden

Amortized over a three-year time period, the hour burdens and time costs for collections of information associated with the asset segregation requirement for financial commitment transactions under proposed rule 18f-4, including the burdens associated with (a) identifying qualifying coverage assets; (b) documenting board-approved policies and procedures; and (c) maintaining required records, are estimated to result in an aggregate average annual hour burden of 163,016 hours and aggregate time costs of $18,210,888.[772] In addition to the internal

768 Proposed rule 18f-4(b)(3)(ii).

769 We assume for purposes of this estimate that funds would implement automated processes for creating a written record of their compliance with the qualifying coverage asset requirements and that a fund would enter into at least one financial commitment transaction per trading day. Based on 250 trading days per year, and assuming 0.1 hours per trading day spent by a general clerk and 0.1 hours per trading day spent by a senior computer operator, we estimate the annual time cost to be (0.1 x 250) = 25 hours per year per fund for each general clerk and senior computer operator.

770 This estimate is based on the following calculations: 50 hours x 984 funds = 49,200 hours.

771 This estimate is based on the following calculation: 25 hours x $57 (hourly rate for a general clerk) = $1,425; 25 hours x $87 (hourly rate for a senior computer operator) = $2,175. $1,425 + $2,175 = $3,600; $3,600 x 984 funds = $3,542,400.

772 These estimates are based on the following calculations: ((3 x 108,240 hours) (years 1, 2 and 3) + 15,744 (year 1) + 984 (year 1) + (3 x 49,200) (years 1, 2 and 3)) ÷ 3 = 163,016 hours; ((3 x $11,345,520) (years 1, 2 and 3) + ($9,912,816 (year 1)) + ($56,088 (year 1)) + (3 x $3,542,400) (years 1, 2 and 3)) ÷ 3 = $18,210,888.

costs described above, we also estimate that each fund would incur a one-time average external cost of $800.

### 4. *Derivatives Risk Management Program*

Proposed rule 18f-4 would require that a fund that engages in more than a limited amount of derivatives transactions, or that uses complex derivatives transactions (as defined in the proposed rule), to adopt and implement a derivatives risk management program.[773] This risk management program would require a fund to adopt and implement policies and procedures reasonably designed to assess and manage the risks of the fund's derivatives transactions, reasonably segregate the functions associated with the program from the portfolio management function of the fund, and periodically review and update the program at least annually.[774] The proposed rule would also require a fund to designate a derivatives risk manager responsible for administering the program and require that the risk manager, no less frequently than quarterly, prepare a written report that describes the adequacy and effectiveness of the fund's risk management program.[775] A fund's board of directors must also (i) approve the fund's derivatives risk management program, including any material changes to the program; (ii) approve the fund's designation of the fund's derivatives risk manager (who cannot be a portfolio manager of the fund); and (iii) review, no less frequently than quarterly, the written report prepared by the fund's derivatives risk manager that describes the adequacy and effectiveness of the fund's risk

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[773] A derivatives risk management program would not be required if the fund complies with a portfolio limitation under which, immediately after entering into any derivatives transaction, the fund's aggregate exposure associated with the fund's derivatives transactions does not exceed 50% of the value of the fund's net assets, and the fund does not use "complex derivatives" (as defined in proposed rule 18f-4(c)(1)).

[774] *See* proposed rule 18f-4(a)(3)(i)(A)-(D).

[775] *See* proposed rule 18f-4(a)(3)(ii)(B) and (C).

management program.[776] Finally, proposed rule 18f-4 would impose certain recordkeeping requirements related to the derivatives risk management program (as described below).

As discussed above in section IV.D.4, DERA staff analysis shows that approximately 10% of all sampled funds had aggregate exposure from derivatives transactions high enough (*i.e.*, aggregate exposure of 50% of net assets or greater) to require that they establish a derivatives risk management program under the proposed rule. The DERA staff analysis also shows an additional approximately 4% of funds had aggregate exposure of between 25-50% of net assets. Commission staff estimates, therefore, that approximately 14% of funds (1,676 funds[777]) and no BDCs would be required to establish a derivatives risk management program. These funds would be subject to the collections of information described below with respect to the derivatives risk management program provision.

Establishing a Derivatives Risk Management Program

As discussed above in section IV.D.4, we estimated that each fund would incur one-time costs to establish and implement a derivatives risk management program in compliance with proposed rule 18f-4, as well as ongoing program-related costs. For purposes of the PRA analysis, we estimate that each fund would incur an average initial burden of 30 hours associated with establishing a derivatives risk management program, including (i) adopting and implementing (including documenting) policies and procedures reasonably designed to assess and manage the risks of the fund's derivatives transactions and designating a derivatives risk manager (24 hours); and (ii) obtaining initial board approval of the derivatives risk management program and the designation of the fund's derivatives risk manager (6 hours). Amortized over a

776 Proposed rule 18f-4(a)(3)(ii).

777 This estimate is based on the following calculation: 11,973 funds x 14% = 1,676 funds. *See supra* note 578.

three-year period, this would be an annual burden per fund of 10 hours. Accordingly, we estimate that the total average annual initial burden for establishing a derivatives risk management program would be 50,280 hours.[778] We also estimate that each fund would incur an initial time cost of $27,346 in relation to this hour burden, for a total initial time cost for all funds of approximately $45,831,896.[779] In addition to the internal costs described above, we also estimate that each fund would incur a one-time average external cost of $1,600 associated with a fund board consulting its outside legal counsel with regard to the required board approval.[780]

In addition to the initial burden, we estimate that each fund would incur an average annual burden of 38 hours associated with its derivatives risk management program, including that: (i) the fund review and update its risk management program at least annually (8 hours); (ii) the derivatives risk manager prepare, on a quarterly basis, a written report that describes the adequacy and effectiveness of the fund's risk management program (24 hours[781]); and (iii) the fund's board review, on a quarterly basis, the written report prepared by the fund's derivatives risk manager that describes the adequacy and effectiveness of the fund's risk management program, and approve any material changes to the derivatives risk management program (6 hours). Accordingly, we estimate that the total average annual burden for establishing a

[778] This estimate is based on the following calculation: 30 hours x 1,676 funds = 50,280 hours.

[779] This estimate is based on the following calculations: 12 hours x $301 (hourly rate for a senior portfolio manager) = $3,612; 12 hours x $455.5 (blended hourly rate for assistant general counsel ($426) and chief compliance officer ($485) = $5,466; 4 hours x $4,400 (hourly rate for a board of 8 directors) = $17,600; 2 hours (for a fund attorney's time to prepare materials for the board's determinations) x $334 (hourly rate for a compliance attorney) = $668. $3,612 + $5,466 + $17,600 + $668 = $27,346; $27,346 x 1,676 funds = $45,831,896.

[780] This estimate is based on the following calculation: 4 hours x $400 (hourly rate for outside legal services) = $1,600.

[781] The estimate is based on the following calculation: 4 quarterly reports x 6 hours to prepare each written report = 24 hours.

derivatives risk management program would be 63,688 hours.[782] We also estimate that each fund would incur an annual time cost of $41,066, for a total annual time cost for all funds of approximately $68,826,616.[783] In addition to the internal costs described above, we also estimate that each fund would incur average annual external costs of $3,200 associated with a fund board's consulting its outside legal counsel with regard to quarterly reviews of the reports prepared by the fund's derivatives risk manager.[784]

<u>Recordkeeping</u>

Proposed rule 18f-4 would require a fund that adopts and implements a derivatives risk management program to maintain (i) a written copy of the policies and procedures adopted by the fund (as required in proposed rule 18f-4(a)(3)) that are in effect, or any time within the past five years were in effect, in an easily accessible place; (ii) copies of any materials provided to the board of directors in connection with its approval of the derivatives risk management program, including any material changes to the program, and any written reports provided to the board relating to the derivatives risk management program, for at least five years after the end of the fiscal year in which the documents were provided (the first two years in an easily accessible place); and (iii) records documenting the periodic reviews and updates required under proposed

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782 This estimate is based on the following calculation: 38 hours x 1,676 funds = 63,688 hours.

783 This estimate is based on the following calculations: Reviewing/updating the risk management program (8 hours): 4 hours x $301 (hourly rate for a senior portfolio manager) = $1,204; 4 hours x $455.5 (blended hourly rate for assistant general counsel ($426) and chief compliance officer ($485) = $1,822; Preparing quarterly reports by the derivatives risk manager (6 hours x 4 reports = 24 hours): 24 hours x $485 (hourly rate for chief compliance officer functioning as proposed derivatives risk manager) = $11,640; Reviewing quarterly reports by the fund's board (1.5 hours x 4 reports = 6 hours): 6 hours x $4,400 (hourly rate for a board of 8 directors) = $26,400. $1,204 + $1,822 + $11,640 + $26,400 = 41,066; $41,066 x 1,676 funds = $68,826,616.

784 This estimate is based on the following calculation: 8 hours (2 hours x 4 quarterly reviews) x $400 (hourly rate for outside legal services) = $3,200.

rule 18f-4(a)(3)(i)(D), for a period of not less than five years (the first two years in an easily accessible place) following each review or update.

We estimate that each fund would incur an annual average burden of 4 hours to retain these records.[785] We therefore estimate that the total annual burden for maintaining these records would be 6,704 hours.[786] We also estimate that each fund would incur an annual time cost of approximately $288, and a total annual time cost for all funds of approximately $482,688 with respect to this hourly burden.[787] We estimate that there are no external costs associated with this collection of information.

Estimated Total Burden

Amortized over a three-year time period, the hour burdens and time costs for collections of information associated with the derivatives risk management program under proposed rule 18f-4, including the burdens associated with (a) establishing a derivatives risk management program; and (b) maintaining required records, are estimated to result in an aggregate average annual hour burden of 65,923 hours and aggregate time costs of $61,644,397.[788] In addition to the internal costs described above, we also estimate that each fund would incur a one-time average external cost of $1,600 and average annual external costs of $3,200.

Estimated Total Burden for Rule 18f-4

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785 We estimate 2 hours spent by a general clerk and 2 hours spent by a senior computer operator.

786 This estimate is based on the following calculation: 4 hours x 1,676 funds = 6,704 hours.

787 This estimate is based on the following calculation: 2 hours x $57 (hourly rate for a general clerk) = $114; 2 hours x $87 (hourly rate for a senior computer operator) = $174. $114 +$ 174 = $288; $288 x 1,676 funds = $482,688.

788 These estimates are based on the following calculations: (50,280 hours (year 1) + (2 x 63,688 hours) (years 2 and 3) + (3 x 6,704 hours) (years 1, 2 and 3)) ÷ 3 = 65,923 hours; ($45,831,896 (year 1) + (2 x $68,826,616) (years 2 and 3) + (3 x $482,688) (years 1, 2 and 3)) ÷ 3 = $61,644,397.

Amortized over a three-year time period, the hour burdens and time costs for collections of information associated with proposed rule 18f-4, including the burdens associated with (a) portfolio limitations for derivatives transactions; (b) asset segregation for derivatives transactions; (c) asset segregation for financial commitment transactions; and (d) derivatives risk management program, are estimated to result in an aggregate average annual hour burden of 1,059,755 hours and aggregate time costs of $171,141,630.[789] In addition to the internal costs described above, we also estimate that each fund would incur an aggregate average one-time external cost of $4,000 and aggregate average annual external costs of $3,200.[790]

### 5. *Amendments to Form N-PORT*

On May 20, 2015, the Commission proposed Form N-PORT, which would require funds to report information within thirty days after the end of each month about their monthly portfolio holdings to the Commission in a structured data format. Preparing a report on Form N-PORT is mandatory and a collection of information under the PRA, and the information required by Form N-PORT would be data-tagged in XML format. Responses to the reporting requirements would be kept confidential for reports filed with respect to the first two months of each quarter; the third month of the quarter would not be kept confidential, but made public sixty days after the quarter end.

Prior Burden Estimate for Proposed Form N-PORT

789 These estimates are based on the following calculations: (196,147 hours: portfolio limitations + 634,669 hours: asset segregation (derivatives) + 163,016 hours: asset segregation (financial commitment transactions) + 65,923 hours (risk management program) = 1,059,755 hours; ($20,386,028: portfolio limitations + $70,900,317: asset segregation (derivatives) + $18,210,888: asset segregation (financial commitment transactions) + $61,644,397 (risk management program) = $171,141,630.

790 These estimates are based on the following calculations: One-time costs: ($800: portfolio limitations + $800: asset segregation (derivatives) + $800: asset segregation (financial commitment transactions) + $1,600 (risk management program) = $4,000; Annual costs: ($3,200: risk management program).

In the Investment Company Reporting Modernization Release, we estimated that, for the 35% of funds that would file reports on proposed Form N-PORT in house, the per fund aggregate average annual hour burden was estimated to be 178 hours per fund, and the average cost to license a third-party software solution would be $4,805 per fund per year.[791] For the remaining 65% of funds that would retain the services of a third party to prepare and file reports on proposed Form N-PORT on the fund's behalf, we estimated the aggregate average annual hour burden to be 125 hours per fund, and each fund would pay an average fee of $11,440 per fund per year for the services of third-party service provider. In sum, we estimated that filing reports on proposed Form N-PORT would impose an average total annual hour burden of 1,537,572 hours on applicable funds, and all applicable funds would incur on average, in the aggregate, external annual costs of $97,674, 221.[792]

Recordkeeping and Reporting

We are proposing amendments to Form N-PORT that would require each fund that is required to implement a derivatives risk management program as required by proposed rule 18f-4(a)(3) to report for options and warrants, including options on a derivative, such as swaptions.[793] We believe that the enhanced reporting proposed in these amendments would help our staff better monitor price and volatility trends, as well as various funds' risk profiles.

Estimated Total Burden

791 *See* Investment Company Reporting Modernization Release, *supra* note 138, at nn.736-741, 749 and accompanying text.

792 *See id.*, at nn.748 and 751 and accompanying text.

793 *See* Item C.11.c.viii of proposed Form N-PORT.

We estimate that 14% of funds (1,676 funds)[794] would be required to file, on a monthly basis, additional information on Form N-PORT as a result of the proposed amendments. We estimate that each fund that files reports on Form N-PORT in house (35%, or 587 funds) would require an average of approximately 2 burden hours to compile (including review of the information), tag, and electronically file the additional information in light of the proposed amendments for the first monthly filing and an average of approximately 1 burden hour for each subsequent monthly filing. Therefore, we estimate the per fund average annual hour burden associated with the incremental changes to Form N-PORT as a result of the proposed amendments for these funds would be an additional 13 hours for the first year[795] and an additional 12 hours for each subsequent year.[796] We further estimate an upper bound on the initial annual costs to funds choosing this option of $3,352 per fund[797] with annual ongoing costs of $2,991 per fund.[798] Amortized over three years, the average annual hour burden would be an

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794 Commission staff estimates, therefore, that approximately 14% of funds (1,676 funds) would be required to establish a derivatives risk management program. *See supra* note 612 and accompanying text.

795 The estimate is based on the following calculation: (1 filing x 2 hours) + (11 filings x 1 hour) = 13 burden hours in the first year.

796 This estimate is based on the following calculation: (12 filings x 1 hour) = 12 burden hours in each subsequent year.

797 This estimate is based upon the following calculations: $3,352 in internal costs = ($3,196 = 1 hour x $303/hour for a senior programmer) + (2.5 hours x $312/hour for a senior database administrator) + (2 hours x $266/hour for a financial reporting manager) + (2 hours x $198/hour for a senior accountant) + (2 hours x $157/hour for an intermediate accountant) + (2 hours x $301/hour for a senior portfolio manager) + (1.5 hours x $283/hour for a compliance manager)). *See* Investment Company Reporting Modernization Release, *supra* note 138, at n.658 and accompanying text.

798 This estimate is based upon the following calculations: $2,991 in internal costs = (2.14 hours x $266/hour for a financial reporting manager) + (2.14 hours x $198/hour for a senior accountant) + (2.14 hours x $157/hour for an intermediate accountant) + (2.14 hours x $301/hour for a senior portfolio manager) + (1.71 hours x $283/hour for a compliance manager) + (1.71 hours x $312/hour for a senior database administrator)). *See* Investment Company Reporting Modernization Release, *supra* note 138, at n. 659 and accompanying text.

additional 12 hours per fund[799] and the aggregate average annual cost would be an additional $3,111 per fund.[800]

We estimate that 65% of funds (1,075 funds) would retain the services of a third party to provide data aggregation, validation and/or filing services as part of the preparation and filing of reports on proposed Form N-PORT on the fund's behalf. For these funds, we estimate that each fund would require an average of approximately 3 hours to compile and review the information with the service provider prior to electronically filing the monthly report for the first time and an average of .5 burden hours for each subsequent monthly filing. Therefore, we estimate the per fund average annual hour burden associated with the incremental changes to proposed Form N-PORT as a result of the proposed amendments for these funds would be an additional 8.5 hours for the first year[801] and an additional 6 hours for each subsequent year.[802] We further estimate an upper bound on the initial costs to funds choosing this option of $2,319 per fund[803] with annual ongoing costs of $1,517 per fund.[804] Amortized over three years, the aggregate average annual

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799 The estimate is based on the following calculation: (13 + (12 x 2)) ÷ 3 = 12.33.

800 The estimate is based on the following calculation: ($3,352 + ($2,991 x 2)) ÷ 3 = $3,111

801 The estimate is based on the following calculation: (1 filing x 3 hours) + (11 filings x 0.5 hour) = 8.5 burden hours in the first year.

802 This estimate is based on the following calculation: 12 filings x 0.5 hour = 6 burden hours in each subsequent year.

803 This estimate is based upon the following calculations: $2,319 in internal costs = (1.5 hours x $303/hour for a senior programmer) + (2.5 hours x $312/hour for a senior database administrator) + (.9 hours x $266/hour for a financial reporting manager) + (.9 hours x $198/hour for a senior accountant) + (.9 hours x $157/hour for an intermediate accountant) + (.9 hours x $301/hour for a senior portfolio manager) + (.9 hours x $283/hour for a compliance manager)). *See* Investment Company Reporting Modernization Release, *supra* note 138, at n.660 and accompanying text.

804 This estimate is based upon the following calculations: $1,517 in internal costs = (1 hours x $266/hour for a financial reporting manager) + (1 hours x $198/hour for a senior accountant) + (1 hours x $157/hour for an intermediate accountant) + (1 hours x $301/hour for a senior portfolio manager) + (1 hours x $283/hour for a compliance manager) + (1 hours x $312/hour for a senior database administrator)). *See* Investment Company Reporting Modernization Release, at n. 661 and accompanying text.

hour burden would be an additional 7 hours per fund,[805] with average annual ongoing costs of $1,784 per fund.[806]

In sum, we estimate that the proposed amendments to Form N-PORT would impose an average total annual hour burden of an additional 14,667 hours on applicable funds,[807] and an average additional total cost of $3,768,933 on applicable funds.[808] We do not anticipate any change to the total external annual costs of $97,674,221.[809]

### *6. Amendments to Form N-CEN*

On May 20, 2015, we proposed to amend rule 30a-1 to require all funds to file reports with certain census-type information on proposed Form N-CEN with the Commission on an annual basis. Proposed Form N-CEN would be a collection of information under the PRA, and is designed to facilitate the Commission's oversight of funds and its ability to monitor trends and risks. The collection of information under Form N-CEN would be mandatory for all funds, and responses would not be kept confidential.

Prior Burden Estimate for Proposed Form N-CEN

In the Investment Company Reporting Modernization Release, the staff estimated that the Commission would receive an average of 3,146 reports per year, based on the number of existing Form N-SAR filers, including responses from 2,419 management companies.[810] We estimated

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805 The estimate is based on the following calculation: (8.5 + (6 x 2)) ÷ 3 = 6.83.

806 The estimate is based on the following calculation: ($2,319 + ($1,517 x 2)) ÷ 3 = $1,784

807 The estimate is based on the following calculation: (587 funds x 12 hours) + (1,089 funds x 7 hours) = 14,667 hours.

808 The estimate is based on the following calculation: (587 funds x $3,111) + (1,089 funds x $1,784) = $3,768,933.

809 *See* Investment Company Reporting Modernization Release, *supra* note 138, at n.751 and accompanying text.

810 This estimate is based on 2,419 management companies and 727 UITs filing reports on Form N-

that management investment companies would require 33.35 annual burden hours in the first year[811] and 13.35 annual burden hours in each subsequent year for preparing and filing reports on proposed Form N-CEN. We further estimated that all Form N-CEN filers would have an aggregate annual paperwork related expenses of $12,395,064 for reports on Form N-CEN.[812] We also estimated that all applicable funds would incur, in the aggregate, external annual costs of $1,748,637, which would include the costs of registering and maintaining LEIs for funds.

Recordkeeping and Reporting

We are proposing amendments to Form N-CEN to identify whether the fund relied upon proposed rule 18f-4. Specifically, the proposed amendments to Form N-CEN would require a fund to identify the portfolio limitation(s) on which the fund relied during the reporting period.

Estimated Total Burden

As discussed above, as part of the Investment Company Modernization Release proposal, funds would be required to identify if they relied upon ten different rules under the Act during the reporting period.[813] In addition to the paperwork costs associated with collecting and

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SAR as of Dec. 31, 2014. UITs would not be required to complete Item 31 of proposed Form N-CEN. *See* General Instruction A of proposed Form N-CEN.

811 This estimate is based on the following calculation: 13.35 hours for filings + 20 additional hours for the first filing = 33.35 hours.

812 This estimate is based on annual ongoing burden hour estimate of 32,294 burden hours for management companies (2,419 management companies x 13.35 hours per filing) plus 6,623 burden hours for UITs (727 UITs x 9.11 burden hours per filing), for a total estimate of 38,917 burden ongoing hours. This was then multiplied by a blended hourly wage of $318.50 per hour, $303 per hour for Senior Programmers and $334 per hour for compliance attorneys, as we believe these employees would commonly be responsible for completing reports on proposed Form N-CEN ($318.50 x 38,917 = $12,395,064.50). *See* Investment Company Reporting Modernization Release, *supra* note 138, at n.723 and accompanying text.

813 *See supra* section IV.D.7.d; *see also* Item 31 of Proposed Form N-CEN.

documenting the requirements under proposed rule 18f-4 ,[814] we believe that there are additional paperwork cost relating to identifying the portfolio limitation(s) on which a fund relied on proposed Form N-CEN. We therefore estimate that 2,419 funds would incur an average annual hour burden of .25 hours for the first year to compile (including review of the information), tag, and electronically file the additional information in light of the proposed amendments, and an average annual hour burden of approximately .1 hours for each subsequent year's filing. We further estimate an upper bound on the initial costs to funds choosing this option of $80 per fund[815] with annual ongoing costs of $32 per fund.[816] Amortized over three years, the aggregate average annual hour burden would be an additional .15 hours per fund,[817] with average annual ongoing costs of $48 per fund.[818]

In sum, we estimate that the proposed amendments to Form N-CEN would impose an average total annual hour burden of an additional 363 hours on applicable funds,[819] and an average additional total cost of $115,616 on applicable funds.[820] We do not anticipate any change to the total external annual costs of $1,748,637.[821]

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814 *See supra* section V.B.1.

815 This estimate is based on multiplying .25 hours by a blended hourly wage of $318.50 per hour, $303 per hour for Senior Programmers and $334 per hour for compliance attorneys, as we believe these employees would commonly be responsible for completing reports on proposed Form N-CEN ($318.50 x .25 = $80). *See* Investment Company Reporting Modernization Release, *supra* note 138, at n.723 and accompanying text.

816 This estimate is based on multiplying .1 hours by a blended hourly wage of $318.50 per hour, $303 per hour for Senior Programmers and $334 per hour for compliance attorneys, as we believe these employees would commonly be responsible for completing reports on proposed Form N-CEN ($318.50 x .1 = $32). *See* Investment Company Reporting Modernization Release, *supra* note 138, at n.723 and accompanying text.

817 The estimate is based on the following calculation: (.25 + (.1 x 2)) ÷ 3 = .15 hours

818 The estimate is based on the following calculation: ($80 + ($32 x 2)) ÷ 3 = $48

819 The estimate is based on the following calculation: (2,419 funds x .15 hours) = 363 hours.

820 This estimate is based on annual ongoing burden estimate of 363 burden hours for management

## C. Request for Comments

We request comment on whether our estimates for burden hours and any external costs as described above are reasonable. Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments in order to: (i) evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (ii) evaluate the accuracy of the Commission's estimate of the burden of the proposed collections of information; (iii) determine whether there are ways to enhance the quality, utility, and clarity of the information to be collected; and (iv) determine whether there are ways to minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology.

The agency has submitted the proposed collection of information to OMB for approval. Persons wishing to submit comments on the collection of information requirements of the proposed amendments should direct them to the Office of Management and Budget, Attention Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and should send a copy to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549 1090, with reference to File No. S7-24-15. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this Release; therefore, a comment to

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companies (2,419 management companies x .15 hours per filing). This was then multiplied by a blended hourly wage of $318.50 per hour, $303 per hour for Senior Programmers and $334 per hour for compliance attorneys, as we believe these employees would commonly be responsible for completing reports on proposed Form N-CEN ($318.50 x 363 = $115,616). *See* Investment Company Reporting Modernization Release, *supra* note 138, at n.723 and accompanying text.

821 *See* Investment Company Reporting Modernization Release, *supra* note 138, at n.769 and accompanying text.

OMB is best assured of having its full effect if OMB receives it within 30 days after publication of this Release. Requests for materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-24-15, and be submitted to the Securities and Exchange Commission, Office of FOIA Services, 100 F Street, NE., Washington, DC 20549-2736.

## VI. INITIAL REGULATORY FLEXIBILITY ACT ANALYSIS

This Initial Regulatory Flexibility Analysis has been prepared in accordance with section 3 of the Regulatory Flexibility Act ("RFA").[822] It relates to proposed rule 18f-4 and proposed amendments to Form N-PORT and Form N-CEN.

### A. Reasons for and Objectives of the Proposed Actions

The use of derivatives by funds implicates certain requirements under the Investment Company Act, including section 18 of that Act.[823] In particular, section 18 limits a fund's ability to obtain leverage or incur obligations to persons other than the fund's common shareholders through the issuance of senior securities, as defined in that section.[824] As discussed above, funds and their counsel, in light of the guidance we provided in Release 10666 and provided by our staff, have applied the segregated account approach to, or otherwise sought to cover, many types of transactions other than those specifically addressed in Release 10666, including various derivatives and other transactions that implicate section 18.[825] We have determined to propose a new approach to funds' use of derivatives in order to address the investor protection purposes and concerns underlying section 18 of the Act and to provide an updated and more

822 5 U.S.C. 603.

823 *See supra* section I.

824 *See supra* section I.

825 *See supra* section II.B.3.

comprehensive approach to the regulation of funds' use of derivatives transactions in light of the dramatic growth in the volume and complexity of the derivatives markets over the past two decades and the increased use of derivatives by certain funds.

The Commission is proposing a new exemptive rule and amendments to Form N-PORT and Form N-CEN that are designed to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives, as well as certain other transactions that implicate section 18 of the Act, and to more effectively address the purposes and concerns underlying section 18.[826] Specifically, proposed rule 18f-4 is designed both to impose a limit on the leverage a fund relying on the rule may obtain through derivatives transactions and financial commitment transactions, and to require the fund to have qualifying coverage assets to meet its obligations under those transactions, in order to address the undue speculation concern expressed in section 1(b)(7) and the asset sufficiency concern expressed in section 1(b)(8).[827] In addition, the derivatives risk management program requirement is designed to complement the proposed rule's portfolio limitations and asset segregation requirements by requiring funds subject to the requirement to adopt and implement a derivatives risk management program that addresses the program elements specified in the rule, including the assessment and management of the risks associated with the fund's derivatives transactions.[828] The program would be administered by a derivatives risk manager designated by the fund and approved by the fund's board of directors.[829] The amendments to Form N-PORT require the reporting of certain risk metrics (vega and gamma) but only by those funds that engage in more than a limited amount of derivatives

826 *See supra* section III.

827 *See supra* section III.A.

828 *See supra* section III.A.

829 *See supra* section III.A.

transactions, by virtue of meeting the threshold requiring them to implement a derivatives risk management program as required by proposed rule 18f-4(a)(3). Last, the amendments to Form N-CEN would require a fund to identify the portfolio limitation(s) on which the fund relied during the reporting period.

### B. Legal Basis

The Commission is proposing new rule 18f-4 under the authority set forth in sections 6(c), 12(a), 31(a), and 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a-6(c), 80a-12(a), 80a-31(a), and 80a-38(a)]. The Commission is proposing amendments to proposed Form N-PORT and Form N-CEN under the authority set forth in sections 8, 30, and 38 of the Investment Company Act of 1940 [15 U.S.C. 80a-8, 80a-30, 80a-38].

### C. Small Entities Subject to Proposed Rule 18f-4 and Amendments to Form N-PORT and Form N-CEN

An investment company is a small entity if, together with other investment companies in the same group of related investment companies, it has net assets of $50 million or less as of the end of its most recent fiscal year.[830] Commission staff estimates that, as of June 2015, approximately 110 open and closed-end funds are small entities. We discuss below the percentage of small funds that the staff estimates may seek to rely on the proposed rule, and the percentage of small funds that may be required to comply with the various aspects of the proposed rule.

### D. Projected Reporting, Recordkeeping, and Other Compliance Requirements

#### 1. *Portfolio Limitations for Derivatives Transactions*

Proposed rule 18f-4 would require a fund that engages in derivatives transactions in reliance on the rule, including any small entities that rely on the rule, to comply with one of two

[830] *See* rule 0-10(a) under the Investment Company Act.

alternative portfolio limitations.[831] A fund that relies on the exposure-based portfolio limit would be required to operate so that its aggregate exposure under senior securities transactions, measured immediately after entering into any such transaction, does not exceed 150% of the fund's net assets.[832] Under the risk-based portfolio limit, a fund generally would be required to demonstrate, using a VaR calculation, that its derivatives transactions, in the aggregate, result in an investment portfolio that is subject to less market risk than if the fund did not use such derivatives.[833] A fund that elects the risk-based portfolio limitation under the proposed rule would be permitted to obtain exposure under its derivatives transactions and other senior securities of up to 300% of the fund's net assets.[834]

The proposed rule would require that for a fund relying on the rule, a fund's board of directors, including a majority of the directors who are not interested persons of the fund, approve which of the two alternative portfolio limitations will apply to the fund.[835] In addition, the proposed rule would require a fund to maintain a record of each determination made by the fund's board that the fund will comply with one of the portfolio limitations under the proposed rule, which would include the fund's initial determination as well as a record of any determination made by the fund's board to change the portfolio limitation.[836] The fund also would be required to maintain a written record demonstrating that immediately after the fund

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[831] Proposed rule 18f-4(a)(1).

[832] Proposed rule 18f-4(a)(1)(i).

[833] Proposed rule 18f-4(a)(1)(ii).

[834] Proposed rule 18f-4(a)(1)(ii).

[835] Proposed rule 18f-4(a)(5)(i).

[836] *See* proposed rule 18f-4(a)(6)(i). The fund would be required to maintain this record for a period of not less than five years (the first two years in an easily accessible place) following each determination.

entered into any senior securities transaction, the fund complied with the portfolio limitation applicable to the fund immediately after entering into the senior securities transaction, reflecting the fund's aggregate exposure, the value of the fund's net assets and, if applicable, the fund's full portfolio VaR and its securities VaR.[837]

As discussed above in section IV, our staff estimates that the one-time operational costs necessary to establish and implement an exposure-based portfolio limitation would range from $20,000 to $150,000 per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund.[838] Staff also estimates that each fund would incur ongoing costs related to implementing a 150% exposure-based portfolio limitation under proposed rule 18f-4. Staff estimates that such costs would range from 20% to 30% of the one-time costs discussed above. Thus, staff estimates that a fund would incur ongoing annual costs associated with the 150% exposure-based portfolio limit that would range from $4,000 to $45,000.

As discussed above in section IV.D.1, in the DERA staff analysis, 68% of all of the sampled funds did not have any exposure to derivatives transactions. These funds thus do not appear to use derivatives transactions or, if they do use them, do not appear to do so to a material extent. We estimate that approximately 32% of funds – the percentage of funds that did have derivatives exposure in the DERA sample – are more likely to enter into derivatives transactions and therefore are more likely to incur costs associated with either the exposure-based portfolio limit or the risk-based portfolio limit. Excluding approximately 4% of all funds (corresponding

837 *See* proposed rule 18f-4(a)(6)(iv). The fund would be required to maintain this record for a period of not less than five years (the first two years in an easily accessible place) following each senior securities transaction entered into by the fund.

838 *See* section IV.

to the percentage of sampled funds that had aggregate exposure of 150% or more of net assets and for which we have estimated costs for the risk-based limit), we estimate that 28% of funds would incur the costs associated with the exposure-based portfolio limit. Staff also estimates that 28% of small funds (approximately 31 small funds) enter into at least some derivatives transactions, and would therefore incur the costs associated with the exposure-based portfolio limit.

As with the costs discussed above regarding the exposure-based portfolio limit, we expect that funds would incur one-time and ongoing operational costs to establish and implement a risk-based exposure limit, including the VaR test. We expect that a fund that seeks to comply with the 300% aggregate exposure limit would incur the same costs as those that we estimated above in order to establish and implement the 150% exposure-based portfolio limit. Accordingly, we estimate below the costs we believe a fund would incur to comply with the VaR test. Our staff estimates that the one-time operational costs necessary to establish and implement a VaR test would range from \$60,000 to \$180,000 per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund. Staff also estimates that each fund would incur ongoing costs related to implementing a VaR test under proposed rule 18f-4. Staff estimates that such costs would range from 20% to 30% of the one-time costs discussed above. Thus, staff estimates that a fund would incur ongoing annual costs associated with the VaR test aspect of the risk-based exposure limit that would range from \$12,000 to \$54,000. DERA staff estimates that approximately 4% of all funds sampled had aggregate exposure of 150% (or greater) of net assets. We estimate therefore, that 4% of funds would rely on the proposed rule, and comply with the risk-based portfolio limit. Staff also estimates that 4% of small funds (approximately 4 small funds) would rely on the proposed rule, and comply with the risk-based portfolio limit.

### 2. *Asset Segregation*

Under proposed rule 18f-4, a fund, including a fund that is a small entity, that enters into derivatives transactions in reliance on the rule would be required to manage the risks associated with its derivatives transactions by maintaining an amount of qualifying coverage assets designed to enable the fund to meet its obligations arising from such transactions.[839] A fund's board, including a majority of the fund's independent directors, would be required to approve the fund's policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets.[840] A fund that would be required to maintain an amount of qualifying coverage assets under the proposed rule also would be subject to certain recordkeeping requirements. The proposed rule would require that qualifying coverage assets for derivatives transactions be identified on the books and records of the fund at least once each business day.[841] In addition, the fund would be required to maintain a written copy of the policies and procedures approved by the board regarding the fund's maintenance of qualifying coverage assets, as required under the proposed rule.[842]

Our staff estimates that the one-time operational costs necessary to establish and implement the proposed asset segregation requirements would range from $25,000 to $75,000 per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the funds comprising the fund. Staff also estimates that each fund

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839 *See* proposed rule 18f-4(a)(2).

840 *See* proposed rule 18f-4(a)(5)(ii).

841 *See* proposed rules 18f-4(a)(2) and 18f-4(a)(6)(v).

842 *See* proposed rule 18f-4(a)(6)(ii).

would incur ongoing costs related to implementing the asset segregation requirements under proposed rule 18f-4. Staff estimates that such costs would range from 65% to 75% of the one-time costs discussed above. Thus, staff estimates that a fund would incur ongoing annual costs associated with the asset segregation requirements that would range from $16,250 to $56,250. As discussed above in section IV.D.1, in the DERA staff analysis, 68% of all of the sampled funds did not have any exposure to derivatives transactions. These funds thus do not appear to use derivatives transactions or, if they do use them, do not appear to do so to a material extent. Staff estimates that the remaining 32% of funds will seek to rely on the proposed rule 18f-4, as noted above, and therefore comply with the asset segregation requirements. Staff also estimates that 32% of small funds (approximately 35 small funds) will seek to rely on proposed rule 18f-4, and therefore comply with the asset segregation requirements.

### 3. *Derivatives Risk Management Program*

We are proposing measures under rule 18f-4 that will help enhance derivatives risk management by requiring that any fund, including a small entity, that engages in more than a limited amount of derivatives transactions pursuant to the proposed rule, or that uses complex derivatives transactions, adopt and implement a derivatives risk management program.[843] This risk management program would require a fund have policies and procedures reasonably designed to assess and manage the risks of the fund's derivatives transactions.[844] The program is designed to be tailored by each fund and its adviser to the particular types of derivatives used by the fund and the manner in which those derivatives relate to the fund's investment portfolio and strategy. Funds that make only limited use of derivatives would not be subject to the proposed

843 *See* proposed rule 18f-4(a)(3).

844 *See* proposed rule 18f-4(a)(3).

condition requiring the adoption of a formalized derivatives risk management program. A fund that makes only limited use of derivatives, however, would need to monitor its investments in derivatives to confirm that its aggregate exposure to derivatives transactions is not more than 50% of its NAV and that it does not use complex derivatives.

Under the proposed rule, a fund's board of directors (including a majority of the directors who are not interested persons of the fund) must approve the fund's derivatives risk management program, including any material changes to the program, if applicable.[845] A fund that has a risk management program would be required to designate a person as a derivatives risk manager responsible for administering the program and such derivatives risk manager would be required to provide a written report to the fund's board of directors, no less frequently than quarterly, that reviews the adequacy and effectiveness of its implementation.[846] We note that some funds, and in particular smaller funds for example, may not have appropriate existing personnel capable of fulfilling the responsibilities of the proposed derivatives risk manager, or may choose to hire a derivatives risk manager rather than assigning that responsibility to a current employee or officer of the fund or the fund's investment adviser who is not a portfolio manager. We would expect that a fund that is required to hire a new derivatives risk manager would likely incur costs on the higher end of our estimated range of costs provided below.

A fund that is required to have a derivatives risk management program under the proposed rule would be required to maintain a written copy of the fund's risk management program and any associated policies and procedures that are in effect, or at any time within the

845 *See* proposed rule 18f-4(a)(3)(ii)A.

846 *See* proposed rule 18f-4(a)(3)(ii)B and C.

past five years, were in effect in an easily accessible place.[847] In addition, a fund would be required to maintain copies of any materials provided to the board of directors in connection with its approval of the derivatives risk management program, including any material changes to the program, and any written reports provided to the board of directors relating to the program.[848]

As discussed in the Economic Analysis section, our staff estimates that the one-time costs necessary to establish and implement a derivatives risk management program would range from $65,000 to $500,000 per fund, depending on the particular facts and circumstances and current derivatives risk management practices of the fund. Staff estimates that each fund would incur ongoing program-related costs, as a result of proposed rule 18f-4, that range from 65% to 75% of the one-time costs necessary to establish and implement a derivatives risk management program. Thus, staff estimates that a fund would incur ongoing annual costs associated with proposed rule 18f-4 that would range from $42,250 to $375,000. Under the proposed rule, a fund that has no greater than 50% aggregate exposure associated with its derivatives transactions would not be required to establish a derivatives risk management program. DERA staff analysis shows that approximately 10% of all sampled funds had aggregate exposure from derivatives transactions high enough (*i.e.*, aggregate exposure of 50% of net assets or greater) to require that they establish a derivatives risk management program under the proposed rule. The DERA staff analysis also shows that approximately 4% of additional funds had aggregate exposure of between 25 and 50% of net assets. In light of this, Commission staff estimates that approximately 14% of funds would establish a derivatives risk management program. Staff also

847 *See* proposed rule 18f-4(a)(6)(iii)A.

848 *See* proposed rule 18f-4(a)(6)(iii)B. The fund would be required to maintain this record for a period of not less than five years after the end of the fiscal year in which the documents were provided (the first two years in an easily accessible place).

estimates that approximately 14% of small funds (approximately 15 small funds) would establish a derivatives risk management program.

### 4. *Financial Commitment Transactions*

Under our proposed rule, a fund may also enter into financial commitment transactions, notwithstanding the requirements of section 18(a)(1), section 18(f)(1) and section 61 of the Investment Company Act provided that the fund maintains qualifying coverage assets, identified on the books and records of the fund and determined at least once each business day, with a value equal to at least the fund's aggregate financial commitment obligations.[849] In addition, the fund's board of directors (including a majority of the directors who are not interested persons of the fund) would be required to approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets.[850] The fund would also be required to maintain a written copy of the policies and procedures approved by the board of directors that are in effect, or at any time within the past five years were in effect, in an easily accessible place.[851] In addition, the fund would be required to maintain a written record reflecting the amount of each financial commitment obligation associated with each financial commitment transaction entered into by the fund and identifying the qualifying coverage assets maintained by the fund with respect to each financial commitment obligation, as determined by the fund at least once each business day, for a period of not less than five years (the first two years in an easily accessible place).[852]

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[849] Proposed rule 18f-4(b)(1). *See also* proposed rule 18f-4(c)(5) (definition of financial commitment obligation).

[850] Proposed rule 18f-4(b)(2).

[851] Proposed rule 18f-4(b)(3)(i).

[852] Proposed rule 18f-4(b)(3)(ii).

Our staff estimates that the one-time operational costs necessary to establish and implement the proposed asset segregation requirements would range from $25,000 to $75,000 per fund. Staff also estimates that each fund would incur ongoing costs related to implementing the asset segregation requirements under proposed rule 18f-4. Staff estimates that such costs would range from 65% to 75% of the one-time costs discussed above. Thus, staff estimates that a fund would incur ongoing annual costs associated with the asset segregation requirements that would range from $16,250 to $56,250. DERA staff analysis shows that approximately 3% of all sampled funds enter into at least some financial commitment transactions, but do not use derivatives transactions (or other senior securities transactions). Staff estimates, therefore, that 3% of funds would comply with the asset segregation requirements in proposed rule 18f-4 applicable to financial commitment transactions.[853] Staff also estimates that 3% of small funds (approximately 3 small funds) would comply with the asset segregation requirements in proposed rule 18f-4 applicable to financial commitment transactions.

5. *Amendments to Proposed Form N-PORT*

We are proposing amendments to proposed Form N-PORT to require the reporting of certain risk metrics (vega and gamma) but only by those funds that engage in more than a limited amount of derivatives transactions, by virtue of meeting the threshold requiring them to implement a derivatives risk management program as required by proposed rule 18f-4(a)(3).[854] As discussed above, we propose to limit the reporting of vega and gamma because: (i) we

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853 The estimate of affected funds does not include money market funds or BDCs. We understand, however, that both money market funds and BDCs may engage in certain types of financial commitment transactions. We estimate that 537 money market funds and 88 BDCs would also comply with the asset segregation requirements in proposed rule 18f-4 (applicable to financial commitment transactions). Based on information in filings submitted to the Commission, we believe that there are no money market funds that are small entities. The Commission staff further estimates that, as of June 2015, approximately 29 BDCs are small entities.

854 *See supra* section III.G. *See also* proposed rule 18f-4(a)(3).

understand that there are added burdens to reporting risk-metrics and we are therefore proposing to limit the reporting of these risk metrics to only those funds who are engaged in more than a limited amount of derivatives transactions or that use certain complex derivatives transactions, as opposed to funds that engage in a more limited use of derivatives; and (ii) we believe many of the funds that would be required to implement a derivatives risk management program and that invest in derivatives as part of their investment strategy currently calculate risk metrics for their own internal risk management programs, albeit, for internal reporting purposes.[855] We anticipate that the enhanced reporting proposed in these amendments would help our staff better monitor price and volatility trends and various funds' risk profiles. Risk metrics data reported on Form N-PORT that is made publicly available also would inform investors and assist users in assessing funds' relative price and volatility risks and the overall price and volatility risks of the fund industry – particularly for those funds that use investments in derivatives as an important part of their trading strategy.

All funds that would be required to implement a derivatives risk management program as required by proposed rule 18f-4(a)(3) would be subject to the proposed amendments to Form N-PORT, including funds that are small entities. For smaller funds and fund groups[856] we proposed an extra 12 months (or 30 months after the effective date) to comply with the proposed Form

855 Part C of proposed Form N-PORT would require a fund and its consolidated subsidiaries to disclose its schedule of investments and certain information about the fund's portfolio of investments. We propose to add Item C.11.c.viii to Part C of proposed Form N-PORT that would require funds that are required to implement a risk management program under proposed rule 18f-4(a)(3) provide the gamma and vega for options and warrants, including options on a derivative, such as swaptions. *See* Item C.11.c.viii of proposed Form N-PORT.

856 For purposes of the extended compliance date only, we proposed that funds that together with other investment companies in the same "group of related investment companies" have net assets of less than $1 billion as of the end of the most recent fiscal year be subject to an extra 12 months to comply with proposed Form N-PORT.

N-PORT reporting requirements. We estimate that 10% of small funds (approximately 11 small funds) would be required to comply with the proposed amendments to Form N-PORT.

We estimate that 1,676 funds would be required to file, on a monthly basis, additional information on Form N-PORT as a result of the proposed amendments.[857] Assuming that 35% of funds (587 funds) would choose to license a software solution to file reports on Form N-PORT in house, we estimate an upper bound on the initial annual costs to file the additional information associated with the proposed amendments for funds choosing this option of $3,352 per fund with annual ongoing costs of $2,991 per fund.[858] We further assume that 65% of funds (1,089 funds) would choose to retain a third-party service provider to provide data aggregation and validation services as part of the preparation and filing of reports on Form N-PORT, and we estimate an upper bound on the initial costs to file the additional information associated with the proposed amendments for funds choosing this option of $2,319 per fund with annual ongoing costs of $1,517per fund.[859] As noted above, we estimate that 10% of small funds (approximately 11 small funds) would be required to comply with the proposed amendments to Form N-PORT. Staff estimates that 35% of small funds (approximately 4 small funds) would choose to license a software solution to file reports on Form N-PORT in house, and 65% of small funds (approximately 7 small funds) would choose to retain a third-party service provider.

### 6. *Amendments to Form N-CEN*

We are proposing amendments to Form N-CEN to require a fund to identify whether the fund relied upon proposed rule 18f-4. Specifically, the proposed amendments to Form N-CEN would require a fund to identify the portfolio limitation(s) under which the fund relied during the

[857] *See supra* note 794.

[858] *See supra* notes 797 and 798, and accompanying text.

[859] *See supra* notes 803 and 804, and accompanying text.

reporting period. As we discussed above, while the costs associated with collecting and documenting the requirements under proposed rule 18f-4 are discussed above,[860] we believe that there are additional costs relating to identifying the portfolio limitation(s) on which a fund relied on proposed Form N-CEN.

We estimate that 2,419 funds would incur initial costs of $80 per fund,[861] with annual ongoing costs of $32 per fund,[862] to compile (including review of the information), tag, and electronically file the additional information in light of the proposed amendments. We do not anticipate any change to the total external annual costs of $1,748,637.[863]

As noted above, we estimate that approximately 110 open and closed-end funds are small entities that would be required to identify the portfolio limitation(s) on which they relied on reports on Form N-CEN during the reporting period.[864]

### E. Duplicative, Overlapping, or Conflicting Federal Rules

Commission staff has not identified any federal rules that duplicate, overlap, or conflict with proposed rule 18f-4 or the proposed amendments to Form N-PORT and Form N-CEN.

### F. Significant Alternatives

The RFA directs the Commission to consider significant alternatives that would accomplish our stated objectives, while minimizing any significant economic impact on small entities. We considered the following alternatives for small entities in relation to our proposal: (i) exempting funds that are small entities from proposed rule 18f-4, or any part thereof, and/or establishing different requirements under proposed rule 18f-4 to account for resources available

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860 *See supra* sections IV.D.1. and IV.D.2.

861 *See supra* note 815.

862 *See supra* note 816.

863 *See supra* note 821.

864 *See supra* section VI.C.

to small entities; (ii) exempting funds that are small entities from the proposed amendments to Form N-PORT, or establishing different disclosure and reporting requirements, or different reporting frequency, to account for resources available to small entities; (iii) the clarification, consolidation, or simplification of compliance requirements under proposed rule 18f-4 for small entities; and (iv) the use of performance rather than design standards.

### *1. Proposed Rule 18f-4*

We do not believe that exempting any subset of funds, including funds that are small entities, from the provisions in proposed rule 18f-4 would permit us to achieve our stated objectives. We also do not believe that it would be desirable to establish different requirements applicable to funds of different sizes under proposed rule 18f-4 to account for resources available to small entities[865] or to use performance standards rather than design standards for small entities where applicable. We note, however, that proposed rule 18f-4 is an exemptive rule, which would require funds to comply with new requirements only if they wish to enter into derivatives transactions and financial commitment transactions. Therefore, if a small entity does not invest in derivatives or financial commitment transactions as part of its investment strategy, then the small entity would not be required to comply with the provisions of proposed rule 18f-4. In the DERA staff analysis, 68% of all funds sampled did not have any exposure to derivatives transactions, which would indicate that many funds, including many small funds, will be unaffected by the proposed rule. However, for small funds that would be affected by our proposed rule, providing an exemption or consolidating or simplifying the proposed rule for small entities could subject investors of small funds that invest in derivatives to a higher degree

[865] We believe, however, that the Commission has accounted for the resources available to small entities by providing some flexibility in the proposed requirement that each fund that is required to adopt and implement a program must *reasonably* segregate the functions associated with the portfolio management of the fund.

of risk than investors to large funds that would be required to comply with the proposed elements of the rule.

The undue speculation concern expressed in section 1(b)(7) of the Act and the asset sufficiency concern reflected in section 1(b)(8) of the Act that the proposed rule is designed to address applies to both small as well as large funds. As discussed throughout this Release, we believe that the proposed rule would result in multiple investor protection benefits, and these benefits should apply to investors in smaller funds as well as investors in larger funds. We therefore do not believe it would be appropriate to exempt funds that are small entities from the portfolio limitation provisions or the asset segregation provisions of proposed rule 18f-4 or establish different requirements applicable to funds of different sizes under these provisions to account for resources available to small entities. Further, we believe that all of the proposed elements of rule 18f-4 should work together to produce the anticipated investor protection benefits, and therefore do not believe it is appropriate to except or modify the requirements for smaller funds because we believe this would limit the benefits to investors in such funds.

We also do not believe it would be appropriate to exempt funds that are small entities from the derivatives risk management requirements of proposed rule 18f-4 or establish different requirements applicable to funds of different sizes. We believe that all of the proposed program elements would be necessary for a fund to effectively assess and manage its derivatives risk, and we anticipate that all of the proposed program elements would work together to produce the anticipated investor protection benefits. We do note that the costs associated with proposed rule 18f-4 would vary depending on the fund's particular circumstances, and thus the proposed rule could result in different burdens on funds' resources. In particular, we expect that a fund that pursues an investment strategy that involves greater derivatives risk may have greater costs associated with its derivatives risk management program. However, we believe that it is appropriate to correlate the costs associated with the proposed rule with the level of derivatives risk facing a fund, and not necessarily with the fund's size. Thus, to the extent a fund that is a small entity faces relatively little derivatives risk, it would incur relatively low costs to comply with proposed rule 18f-4. And, to the extent that a fund that is a small entity that engages in a limited amount of derivatives transactions pursuant to the proposed rule, and does not use complex derivatives transactions, such small entity would not be required to adopt and implement a derivatives risk management program.

#### 2. *Form N-PORT and Form N-CEN*

Similarly, we do not believe that the interests of investors would be served by exempting funds that are small entities from the proposed disclosure and reporting requirements, or subjecting these funds to different disclosure and reporting requirements than larger funds. We believe that all fund investors, including investors in funds that are small entities, would benefit from disclosure and reporting requirements that would permit them to make investment choices that better match their risk tolerances. We also believe that all fund investors would benefit from enhanced Commission monitoring and oversight of the fund industry, which we anticipate would result from the proposed disclosure and reporting requirements.

### G. General Request for Comment

The Commission requests comments regarding this analysis. We request comment on the number of small entities that would be subject to our proposal and whether our proposal would have any effects that have not been discussed. We request that commenters describe the nature of any effects on small entities subject to our proposal and provide empirical data to support the nature and extent of such effects. We also request comment on the estimated compliance burdens of our proposal and how they would affect small entities.

## VII. Consideration of Impact on the Economy

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"), the Commission must advise OMB whether a proposed regulation constitutes a "major" rule. Under SBREFA, a rule is considered "major" where, if adopted, it results in or is likely to result in:

- An annual effect on the economy of $100 million or more;
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment, or innovation.

We request comment on whether our proposal would be a "major rule" for purposes of SBREFA. We solicit comment and empirical data on:

- The potential effect on the U.S. economy on an annual basis;
- Any potential increase in costs or prices for consumers or individual industries; and
- Any potential effect on competition, investment, or innovation.

Commenters are requested to provide empirical data and other factual support for their views to the extent possible.

## VII. Statutory Authority and Text of Proposed Amendments

The Commission is proposing new rule 18f-4 under the authority set forth in sections 6(c), 12(a), 31(a), and 38(a) of the Investment Company Act of 1940 [15 U.S.C. 80a-6(c), 80a-31(a), 80a-12(a), and 80a-38(a)]. The Commission is proposing amendments to proposed Form N-PORT and Form N-CEN under the authority set forth in sections 8, 30, and 38 of the Investment Company Act of 1940 [15 U.S.C. 80a-8, 80a-30, 80a-38].

TEXT OF RULES AND FORMS

**List of Subjects**

**17 CFR Parts 270 and 274**

Investment companies, Reporting and recordkeeping requirements, Securities.

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

**PART 270 - RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940**

1. The authority citation for part 270 continues to read, in part, as follows:

**Authority:** 15 U.S.C. 80a-1 *et seq.*, 80a-34(d), 80a-37, 80a-39, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

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2. Section §270.18f-4 is added to read as follows:

**§ 270.18f-4 Exemption from the requirements of section 18 and section 61 for certain senior securities transactions.**

(a) A registered open-end or closed-end company or business development company (each, including any separate series thereof, a "fund") may enter into derivatives transactions, notwithstanding the requirements of section 18(a)(1) (15 U.S.C. 80a-18(a)(1)), section 18(c) (15 U.S.C. 80a-18(c)), section 18(f)(1) (15 U.S.C. 80a-18(f)(1)) and section 61 (15 U.S.C. 80a-61) of the Investment Company Act; provided that:

(1) The fund complies with one of the following portfolio limitations such that, immediately after entering into any senior securities transaction:

(i) The aggregate exposure of the fund does not exceed 150% of the value of the fund's net assets; or

(ii) The fund's full portfolio VaR is less than the fund's securities VaR and the aggregate exposure of the fund does not exceed 300% of the value of the fund's net assets.

(2) The fund manages the risks associated with its derivatives transactions by maintaining qualifying coverage assets, identified on the books and records of the fund as specified in paragraph (a)(6)(v) of this section and determined at least once each business day, with a value equal to at least the sum of the fund's aggregate mark-to-market coverage amounts and risk-based coverage amounts.

(3) Except as provided in paragraph (a)(4) of this section, the fund adopts and implements a written derivatives risk management program ("program") that is reasonably designed to assess and manage the risks associated with the fund's derivatives transactions.

(i) Required program elements. Each fund required to adopt and implement a program must adopt and implement written policies and procedures reasonably designed to:

A. Assess the risks associated with the fund's derivatives transactions, including an evaluation of potential leverage, market, counterparty, liquidity, and operational risks, as applicable, and any other risks considered relevant;

B. Manage the risks associated with the fund's derivatives transactions (including the risks identified in paragraph (a)(3)(i)(A) of this section, as applicable), including by:

*(i)* Monitoring whether the fund's use of derivatives transactions is consistent with any investment guidelines established by the fund or the fund's investment adviser, the relevant portfolio limitation applicable to the fund under this section, and relevant disclosure to investors; and

*(ii)* Informing persons responsible for portfolio management of the fund or the fund's board of directors, as appropriate, regarding material risks arising from the fund's derivatives transactions;

C. Reasonably segregate the functions associated with the program from the portfolio management of the fund; and

D. Periodically review and update the program at least annually, including any models (including any VaR calculation models used by the fund during the period covered by the review), measurement tools, or policies and procedures that are part of, or used in, the program to evaluate their effectiveness and reflect changes in risks over time.

(ii) Board approval and oversight of the program.

A. The fund shall obtain initial approval of the program, as well as any material change to the program, from the fund's board of directors, including a majority of directors who are not interested persons of the fund;

B. The fund's board of directors, including a majority of directors who are not interested persons of the fund, shall review, no less frequently than quarterly, a written report prepared by the person designated under paragraph (a)(3)(ii)(C) of this section that describes the adequacy of the fund's program and the effectiveness of its implementation; and

C. The fund shall designate an employee or officer of the fund or the fund's investment adviser (who may not be a portfolio manager of the fund) responsible for administering the policies and procedures incorporating the elements of paragraphs (a)(3)(i)(A) through (a)(3)(i)(D) of this section, whose designation must be approved by the fund's board of directors, including a majority of the directors who are not interested persons of the fund.

(4) A derivatives risk management program shall not be required if the fund complies, and monitors its compliance, with a portfolio limitation under which:

(i) Immediately after entering into any derivatives transaction the aggregate exposure associated with the fund's derivatives transactions does not exceed 50% of the value of the fund's net assets; and

(ii) The fund does not enter into complex derivatives transactions.

(5) The fund's board of directors (including a majority of the directors who are not interested persons of the fund) has:

(i) Approved the particular portfolio limitation under which the fund will operate pursuant to paragraph (a)(1) of this section and, if applicable, paragraph (a)(4) of this section;

(ii) Approved policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets, as required under paragraph (a)(2) of this section; and

(iii) If the fund is required to adopt and implement a derivatives risk management program, taken the actions specified in paragraph (a)(3)(ii) of this section.

(6) The fund maintains:

(i) A written record of each determination made by the fund's board of directors under paragraph (a)(5)(i) of this section with respect to the portfolio limitation applicable to the fund for a period of not less than five years (the first two years in an easily accessible place) following each determination;

(ii) A written copy of the policies and procedures approved by the board of directors under paragraph (a)(5)(ii) of this section that are in effect, or at any time within the past five years were in effect, in an easily accessible place; and

(iii) If the fund is required to adopt and implement a derivatives risk management program:

A. A written copy of the policies and procedures adopted by the fund under paragraph (a)(3) of this section that are in effect, or at any time within the past five years were in effect, in an easily accessible place;

B. Copies of any materials provided to the board of directors in connection with its approval of the derivatives risk management program, including any material changes to the program, and any written reports provided to the board of directors relating to the program, for at least five years after the end of the fiscal year in which the documents were provided, the first two years in an easily accessible place; and

C. Records documenting the periodic reviews and updates conducted in accordance with paragraph (a)(3)(i)(D) of this section (including any updates to any VaR calculation models used by the fund and the basis for any material changes thereto), for a period of not less than five years (the first two years in an easily accessible place) following each review or update.

(iv) A written record demonstrating that immediately after the fund entered into any senior securities transaction, the fund complied with the portfolio limitation applicable to the fund immediately after entering into the senior securities transaction, reflecting the fund's aggregate exposure, the value of the fund's net assets and, if applicable, the fund's full portfolio VaR and its securities VaR, for a period of not less than five years (the first two years in an easily accessible place) following each senior securities transaction entered into by the fund.

(v) A written record reflecting the mark-to-market coverage amount and the risk-based coverage amount for each derivatives transaction entered into by the fund and identifying the qualifying coverage assets maintained by the fund with respect to the fund's aggregate mark-to-market and risk-based coverage amounts, as determined by the fund at least once each business day, for a period of not less than five years (the first two years in an easily accessible place).

(b) A fund may enter into financial commitment transactions, notwithstanding the requirements of section 18(a)(1) (15 U.S.C. 80a-18(a)(1)), section 18(c) (15 U.S.C. 80a-18(c)), section 18(f)(1) (15 U.S.C. 80a-18(f)(1)) and section 61 (15 U.S.C. 80a-61) of the Investment Company Act; provided that:

(1) The fund maintains qualifying coverage assets, identified on the books and records of the fund as specified in paragraph (b)(3)(ii) of this section and determined at least once each business day, with a value equal to at least the fund's aggregate financial commitment obligations.

(2) The fund's board of directors (including a majority of the directors who are not interested persons of the fund) has approved policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets, as required under paragraph (b)(1) of this section.

(3) The fund maintains:

(i) A written copy of the policies and procedures approved by the board of directors under paragraph (b)(2) of this section that are in effect, or at any time within the past five years were in effect, in an easily accessible place; and

(ii) A written record reflecting the amount of each financial commitment obligation associated with each financial commitment transaction entered into by the fund and identifying the qualifying coverage assets maintained by the fund with respect to each financial commitment obligation, as determined by the fund at least once each business day, for a period of not less than five years (the first two years in an easily accessible place).

(c) Definitions.

(1) *Complex derivatives transaction* means any derivatives transaction for which the amount payable by either party upon settlement date, maturity or exercise:

(i) Is dependent on the value of the underlying reference asset at multiple points in time during the term of the transaction; or

(ii) Is a non-linear function of the value of the underlying reference asset, other than due to optionality arising from a single strike price.

(2) *Derivatives transaction* means any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument") under which the fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise.

(3) *Exposure* means the sum of the following amounts, determined immediately after the fund enters into any senior securities transaction:

(i) The aggregate notional amounts of the fund's derivatives transactions, provided that a fund may net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms;

(ii) The aggregate financial commitment obligations of the fund; and

(iii) The aggregate indebtedness (and with respect to any closed-end fund or business development company, involuntary liquidation preference) with respect to any senior securities transaction entered into by the fund pursuant to section 18 (15 U.S.C. 80a-18) or 61 (15 U.S.C. 80a-61) of the Investment Company Act without regard to the exemption provided by this section.

(4) *Financial commitment transaction* means any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement (such as an agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner).

(5) *Financial commitment obligation* means the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under a financial commitment transaction. Where the fund is conditionally or unconditionally obligated to deliver a particular asset, the financial commitment obligation shall be the value of the asset, determined at least once each business day.

(6) *Mark-to-market coverage amount* means, for each derivatives transaction, at any time of determination under this section, the amount that would be payable by the fund if the fund were to exit the derivatives transaction at such time; provided that:

(i) If the fund has entered into a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions, the mark-to-market coverage amount for those derivatives transactions may be calculated as the net amount that would be payable by the fund, if any, with respect to all derivatives transactions covered by the netting agreement; and

(ii) The fund's mark-to-market coverage amount for a derivatives transaction may be reduced by the value of assets that represent variation margin or collateral for the amounts payable referred to in paragraph (c)(6) of this section with respect to the derivatives transaction.

(7) *Notional amount* means, with respect to any derivatives transaction:

(i) The market value of an equivalent position in the underlying reference asset for the derivatives transaction (expressed as a positive amount for both long and short positions); or

(ii) The principal amount on which payment obligations under the derivatives transaction are calculated; and

(iii) Notwithstanding paragraphs (c)(7)(i) and (ii) of this section:

A. For any derivatives transaction that provides a return based on the leveraged performance of a reference asset, the notional amount shall be multiplied by the leverage factor;

B. For any derivatives transaction for which the reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity, the notional amount shall be determined by reference to the fund's pro rata share of the notional amounts of the derivatives transactions of such account or entity; and

C. For any complex derivatives transaction, the notional amount shall be an amount equal to the aggregate notional amount of derivatives instruments, excluding other complex derivatives transactions, reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction.

(8) *Qualifying coverage assets* means assets of the fund described in paragraphs (c)(8)(i)-(iii) of this section, provided that the total amount of a fund's qualifying coverage assets shall not exceed the fund's net assets, and that assets of the fund maintained as qualifying coverage assets shall not be used to cover both a derivatives transaction and a financial commitment transaction:

(i) Cash and cash equivalents;

(ii) With respect to any derivatives transaction or financial commitment transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset; and

(iii) With respect to any financial commitment obligation, assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board of directors as provided in paragraph (b)(2) of this section.

(9) *Risk-based coverage amount* means, for each derivatives transaction, an amount, in addition to the derivative transaction's mark-to-market coverage amount, that represents, at any time of determination under this section, a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions, determined in accordance with policies and procedures (which must take into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset) approved by the fund's board of directors as provided in paragraph (a)(5) of this section; provided that:

(i) The risk-based coverage amount may be determined on a net basis for derivatives transactions that are covered by a netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions, in accordance with the terms of the netting agreement; and

(ii) The fund's risk-based coverage amount for a derivatives transaction may be reduced by the value of assets that represent initial margin or collateral for the potential amounts payable referred to in paragraph (c)(9) of this section with respect to the derivatives transaction.

(10) *Senior securities transaction* means any derivatives transaction, financial commitment transaction, or any transaction involving a senior security entered into by the fund pursuant to section 18 (15 U.S.C. 80a-18) or 61 (15 U.S.C. 80a-61) of the Act without regard to the exemption provided by this section.

(11) *Value-at-risk* or *VaR* means an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence interval, provided that:

(i) For purposes of the portfolio limitation described in (a)(1)(ii) of this section:

A. A fund's "*securities VaR*" means the VaR of the fund's portfolio of securities and other investments, but excluding any derivatives transactions;

B. A fund's *"full portfolio VaR"* means the VaR of the fund's entire portfolio, including securities, other investments and derivatives transactions; and

C. A fund must apply its VaR model consistently when calculating the fund's securities VaR and the fund's full portfolio VaR.

(ii) Any VaR model used by a fund for purposes of determining the fund's securities VaR and full portfolio VaR must:

A. Take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, as applicable:

*(i)* Equity price risk, interest rate risk, credit spread risk, foreign currency risk and commodity price risk;

*(ii)* Material risks arising from the nonlinear price characteristics of a fund's investments, including options and positions with embedded optionality; and

*(iii)* The sensitivity of the market value of the fund's investments to changes in volatility;

B. Use a 99% confidence level and a time horizon of not less than 10 and not more than 20 trading days; and

C. If using historical simulation, include at least three years of historical market data.

**PART 274 - FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF 1940**

3. The general authority citation for part 274 continues to read as follows:

**Authority:** 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78*l*, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, 80a-29, and Pub. L. 111-203, sec. 939A, 124 Stat. 1376 (2010), unless otherwise noted.

* * * * *

4. Amend Form N-PORT (referenced in 274.150), as proposed at 80 FR 33712, June 12, 2015, and further amended at 80 FR 62273, September 14, 2015, by:

a. In Part C, revising Item C. 11.c.viii; and
b. In Part C, adding Item C.11.c.ix to read as follows.

**§274.150 Form N-PORT, Monthly portfolio holdings report.**

* * * * *

**Part C: Schedule of Portfolio Investments**

* * * * *

Item C.11.c.viii For funds that are required to implement a risk management program under rule 18f-4(a)(3) under the Investment Company Act, provide:

1. Gamma.

2. Vega.

Item C.11.c.ix Unrealized appreciation or depreciation.

5. Further amend Form N-CEN (referenced in 274.101) as proposed at 80 FR 33712, June 12, 2015, and further amended at 80 FR 62273, September 14, 2015, by:

a. In Part C, adding paragraphs k and l to Item 31.

**§274.101 Form N-CEN, annual report of registered investment companies.**

* * * * *

**Part C. Additional Questions for Management Investment Companies**

* * * * *

Item 31. Reliance on certain rules. Did the Fund rely on any of the following rules under the Act during the reporting period? (check all that apply)

* * * * *

k. Rule 18f-4(a)(1)(i) (17 CFR 270.18f-4(a)(1)(i)): ____
l. Rule 18f-4(a)(1)(ii) (17 CFR 270. 18f-4(a)(1)(ii)): ____

* * * * *

By the Commission.

Brent J. Fields
Secretary

Dated: December 11, 2015

**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76633 / December 14, 2015**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3726 / December 14, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17001**

| | |
|---|---|
| **In the Matter of**<br><br>**CHARLES LOVELESS, CPA,**<br><br>**Respondent.** | **ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER** |

## I.

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

## II.

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

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## III.

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

**Summary**

1. Respondent, a former employee of Diebold, Inc. ("Diebold"), entered into a cooperation agreement with the Division of Enforcement on March 23, 2010, in connection with the Commission's investigation of violations of the federal securities laws at Diebold, and related enforcement proceedings. That investigation and related enforcement proceedings against the company and certain of its former senior executives are now concluded. The Commission, having taken into consideration Respondent's substantial cooperation, enters this Order resolving the matter with respect to Respondent.

2. As described below, Respondent, at the direction of management, made improper accounting entries in Diebold's books, records, and accounts in 2003 and 2004, while he was a finance manager at the company. As a result of the conduct described herein, Respondent caused violations of Section 13(b)(2)(A) of the Exchange Act, and violated Rule 13b2-1 thereunder.

**Respondent**

3. Respondent Charles Loveless, 50, is a resident of Massillon, Ohio. He was a finance manager at Diebold from 2001 to 2006, and reported directly to Michael McKenna. From 2006 to 2008, Loveless was Diebold's Manager of External Reporting. In January 2008, Loveless separated from Diebold. Currently, Loveless is the Finance Director and Controller of a private company in North Canton, Ohio. Loveless is a certified public accountant in Ohio. His license is inactive. Loveless entered into a cooperation agreement with the Division on March 23, 2010.

**Other Relevant Individuals and Entity**

4. Diebold, Inc. is an Ohio corporation headquartered in North Canton, Ohio. Diebold manufactures and sells ATMs and bank security systems. Diebold's common stock is registered with the Commission pursuant to Exchange Act Section 12(b) and is listed on the New York Stock Exchange.

5. Walden O'Dell, 69, is a resident of Columbus, Ohio. O'Dell was the CEO and Chairman of Diebold from 1999 to 2005. He is retired.

6. Gregory Geswein, 60, is a resident of Toledo, Ohio. Geswein was the CFO of Diebold from 2000 to 2005. Subsequently, Geswein was the CFO of Reynolds & Reynolds, Co.

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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.

from 2005 to 2006, and the CFO of Libbey, Inc. from May 2007 through June 2010. Geswein currently operates a restaurant in Akron, Ohio. Geswein is not a certified public accountant.

7. Kevin Krakora, 59, is a resident of Canton, Ohio. Krakora was Diebold's Controller from 2001 through 2005, and the company's CFO from 2005 through March 2008. Krakora was removed as Diebold's CFO in March 2008, and later separated from the company in 2010. From December 2011 through May 2012, Krakora worked part-time as a business consultant. From July 2012 through September 2013, Krakora operated a handyman franchise. Krakora is currently unemployed. Krakora is a certified public accountant in Ohio. His license is inactive.

8. Sandra Miller, 47, is a resident of Houston, Texas. Miller was Diebold's Director of Corporate Accounting from 2002 to 2006. From 2006 through 2011, Miller was the Controller at JoAnn Stores, Inc. Currently Miller is a reporting and compliance director at a private company in Houston, Texas. Miller is a certified public accountant in Ohio.

9. Michael McKenna, 53, is a resident of New Hartford, New York. McKenna was Diebold's Vice President of Global Finance from 2002 to 2005, and the company's Vice President of North American Finance from 2005 through 2007. In July 2007, McKenna separated from Diebold. Since January 2010, McKenna has been the Finance Director and Controller of a private company in Utica, New York. McKenna is a certified public accountant in Ohio. His license is inactive. McKenna entered into a cooperation agreement with the Division of Enforcement on April 19, 2010.

## Background

10. Loveless is a former employee of Diebold, Inc., a public company based in North Canton, Ohio that manufactures and sells ATMs and bank security systems. Loveless was a finance manager at Diebold from 2001 to 2006, and the company's Manager of External Reporting from 2006 to 2008. In 2003 and 2004, Loveless, at the direction of management, made improper accounting entries in Diebold's books, records, and accounts. These improper entries assisted the company and its management in artificially inflating Diebold's reported earnings to meet forecasts.

11. Under generally accepted accounting principles ("GAAP"), an issuer is required to accrue for anticipated liabilities. Under GAAP, a liability should be released upon the occurrence of a specified event or when the estimate should be revised in response to new information. GAAP prohibits maintaining general or excess reserves (e.g., "cookie jar" reserves).

12. As a finance manager at Diebold, Loveless had certain accounting responsibilities for Diebold's North American sales commission accrual account. This account consolidated several sub-accounts maintained by accounting personnel in Diebold's North American business units. In 2003 and 2004, Loveless, and others, including management of Diebold, knew that this account was frequently underaccrued because the business units were not properly recording liabilities. At the direction of management, no action was taken to correct it. In 2003 and 2004, the account was understated by approximately $2.7 million and $300,000, respectively.

13. Loveless also had accounting responsibilities for Diebold's Shipped Not Installed accrual account, which the company at times used as a cookie jar reserve. At the direction of management, on October 4, 2003, Loveless made an improper out-of-period entry increasing the accrual in this account by $250,000, effective as of September 2003 (the third-quarter 2003). On October 7, 2003, Loveless improperly reversed this accrual in the fourth-quarter 2003. There was no legitimate accounting justification for these entries. The improper entries assisted management in artificially inflating the company's reported earnings for the fourth-quarter of 2003.

14. As a result of the conduct described above, Respondent Loveless caused Diebold's violations of Section 13(b)(2)(A) of the Exchange Act, which requires Commission registrants to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the registrant.

15. As a result of the conduct described above, Loveless violated Rule 13b2-1 of the Exchange Act, which states that no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Exchange Act.

## Cooperation

16. Loveless entered into a cooperation agreement with the Division of Enforcement on March 23, 2010, in connection with the Commission's investigation of violations of the federal securities laws at Diebold and related enforcement proceedings. As a result of the investigation, the Commission filed the following enforcement actions, all of which are now concluded:

17. On June 2, 2010, the Commission filed a settled enforcement action against Diebold in which it consented to a final judgment ordering injunctive relief and a $25 million civil penalty. *See SEC v. Diebold, Inc.*, Civ. Action No. 1:10-CV-00908 (D.D.C.) / Lit. Rel. No. 21543.

18. On June 2, 2010, the Commission filed a settled compensation claw-back action against Walden O'Dell, Diebold's former CEO and Chairman, pursuant to Section 304 of the Sarbanes-Oxley Act of 2002, in which he consented to a final judgment ordering him to reimburse $470,016 in cash bonuses, 30,000 shares of Diebold stock, and stock options for 85,000 shares of Diebold stock. *See SEC. v. O'Dell*, Civ. Action No. 1:10-CV-00909 (D.D.C.) / Lit. Rel. No. 21543.

19. On June 2, 2010, the Commission filed a contested enforcement action against Gregory Geswein, Diebold's former CFO. On May 26, 2015, pursuant to a settlement, the court entered a final consent decree against Geswein ordering him to pay $680,000 in disgorgement, a $170,000 civil penalty, and prohibiting him for three years from acting as an officer or director of a public company. *See SEC v. Geswein, et al.*, Civ. Action No. 5:10-CV-01235 (N.D. Ohio) / Lit. Rel. Nos. 21543 and 23268.

20. On June 2, 2010, the Commission filed a contested enforcement action against Kevin Krakora, Diebold's former Controller and later CFO. On May 26, 2015, pursuant to a settlement, the court entered a final consent decree against Krakora ordering him to pay $400,000 in

disgorgement, a $100,000 civil penalty, prohibiting him for three years from acting as an officer or director of a public company, and prohibiting him from appearing or practicing before the Commission as an accountant, with a right to apply for reinstatement after three years. *See SEC v. Geswein, et al.*, Civ. Action No. 5:10-CV-01235 (N.D. Ohio) / Lit. Rel. Nos. 21543 and 23268.

21. On June 2, 2010, the Commission filed a contested enforcement action against Sandra Miller, Diebold's former Director of Corporate Accounting. On May 26, 2015, pursuant to a settlement, the court entered a final consent decree against Miller that permanently enjoins her from aiding and abetting any violation of Section 13(a), Section 13(b)(2)(A), and Section 13(b)(2)(B) of the Exchange Act, and Rules 13a-1, 13a-11, 13a-13, and 12b-20 thereunder, and ordered disgorgement of $29,057, which was waived, and no penalty imposed, based on her financial condition. *See SEC v. Geswein, et al.*, Civ. Action No. 5:10-CV-01235 (N.D. Ohio) / Lit. Rel. Nos. 21543 and 23268.

22. Loveless provided significant cooperation in connection with the Commission's investigation of this matter and the related enforcement actions.

## IV.

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

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent Loveless cease and desist from committing or causing any violations and any future violations of Section 13(b)(2)(A) of the Exchange Act, and Rule 13b2-1 thereunder.

B. Respondent shall, within ten (10) days of the entry of this Order, pay disgorgement of $7,724 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. 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 Charles Loveless 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 Brian O. Quinn, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

C. Respondent acknowledges that the Commission is not imposing a civil penalty based upon his cooperation in a Commission investigation and related enforcement actions. If at any time following the entry of the Order, the Division of Enforcement ("Division") obtains information indicating that Respondent knowingly provided materially false or misleading information or materials to the Commission or in a related proceeding, the Division may, at its sole discretion and with prior notice to the Respondent, petition the Commission to reopen this matter and seek an order directing that the Respondent pay a civil money penalty. Respondent may contest by way of defense in any resulting administrative proceeding whether it knowingly provided materially false or misleading information, but may not: (1) contest the findings in the Order; or (2) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
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. 76634 / December 14, 2015**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3727 / December 14, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17002**

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| **In the Matter of**<br><br>**MICHAEL MCKENNA, CPA,**<br><br>**Respondent.** | **ORDER INSTITUTING CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER** |

## I.

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

## II.

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

1. Respondent, a former employee of Diebold, Inc. ("Diebold"), entered into a cooperation agreement with the Division of Enforcement on April 19, 2010, in connection with the Commission's investigation of violations of the federal securities laws at Diebold, and related enforcement proceedings. That investigation and related enforcement proceedings against the company and certain of its former senior executives are now concluded. The Commission, having taken into consideration Respondent's substantial cooperation, enters this Order resolving the matter with respect to Respondent.

2. As described below, Respondent, often at the direction of management, made improper accounting entries in Diebold's books, records, and accounts in 2003 and 2004 while he was Vice President of Global Finance at the company. As a result of the conduct described herein, Respondent caused violations of Section 13(b)(2)(A) of the Securities Exchange Act of 1934 (the "Exchange Act"), and violated Rule 13b2-1 thereunder.

### Respondent

3. Michael McKenna, 53, is a resident of New Hartford, New York. McKenna was the Vice President of Global Finance at Diebold from 2002 to 2005, and the company's Vice President of North American Finance from 2005 through 2007. In July 2007, McKenna separated from Diebold. Since January 2010, McKenna has been the Finance Director and Controller of a private company in Utica, New York. McKenna is a certified public accountant in Ohio. His license is inactive. McKenna entered into a cooperation agreement with the Division of Enforcement on April 19, 2010.

### Other Relevant Individuals and Entity

4. Diebold, Inc. is an Ohio corporation headquartered in North Canton, Ohio. Diebold manufactures and sells ATMs and bank security systems. Diebold's common stock is registered with the Commission pursuant to Exchange Act Section 12(b) and is listed on the New York Stock Exchange.

5. Walden O'Dell, 69, is a resident of Columbus, Ohio. O'Dell was the CEO and Chairman of Diebold from 1999 to 2005. He is retired.

6. Gregory Geswein, 60, is a resident of Toledo, Ohio. Geswein was the CFO of Diebold from 2000 to 2005. Subsequently, Geswein was the CFO of Reynolds & Reynolds, Co.

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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.

from 2005 to 2006, and the CFO of Libbey, Inc., from May 2007 through June 2010. Geswein currently operates a restaurant in Akron, Ohio. Geswein is not a certified public accountant.

7. Kevin Krakora, 59, is a resident of Canton, Ohio. Krakora was Diebold's Controller from 2001 through 2005, and the company's CFO from 2005 through March 2008. Krakora was removed as Diebold's CFO in March 2008, and later separated from the company in 2010. From December 2011 through May 2012, Krakora worked part-time as a business consultant. From July 2012 through September 2013, Krakora operated a handyman franchise. Krakora is currently unemployed. Krakora is a certified public accountant in Ohio. His license is inactive.

8. Sandra Miller, 47, is a resident of Houston, Texas. Miller was Diebold's Director of Corporate Accounting from 2002 to 2006. From 2006 through 2011, Miller was the Controller at JoAnn Stores, Inc. Currently, she is a reporting and compliance director at a private company in Houston, Texas. Miller is a certified public accountant in Ohio.

9. Charles Loveless, 50, is a resident of Massillon, Ohio. Loveless was a finance manager at Diebold from 2001 to 2006, and the company's Manager of External Reporting from 2006 to 2008. In January 2008, Loveless separated from Diebold. Currently, Loveless is the Finance Director and Controller of a private company in North Canton, Ohio. Loveless is a certified public accountant in Ohio. His license is inactive. Loveless entered into a cooperation agreement with the Division of Enforcement on March 23, 2010.

## Background

10. McKenna is a former employee of Diebold, Inc., a public company based in North Canton, Ohio that manufactures and sells ATMs and bank security systems. McKenna was the Vice President of Global Finance at Diebold from 2002 to 2005, and the company's Vice President of North American Finance from 2005 through 2007. In 2003 and 2004, McKenna, often at the direction of senior management, made improper accounting entries in Diebold's books, records, and accounts. These improper entries assisted the company and its management in artificially inflating Diebold's reported earnings to meet forecasts.

11. Under generally accepted accounting principles ("GAAP"), normally a product must be shipped to the customer or services rendered before revenue can be recognized. An exception exists, however, for what are known as "bill and hold" transactions. With a "bill and hold" transaction, revenue can be recognized on the sale of products prior to delivery to the customer if the GAAP criteria for a bill and hold transaction are met.

12. From at least 2002 through 2007, Diebold improperly used "bill and hold" accounting to recognize revenue on certain transactions it called "F-term" (or "Factory") orders. Diebold recognized revenue on these orders when it shipped products from its factory to a Diebold warehouse. During his tenure at Diebold, McKenna had accounting responsibilities for F-term orders. At the direction of management, McKenna and his subordinates recorded revenue on F-term orders when the company shipped products from its factory to a Diebold warehouse. Many

of these F-term orders, however, did not satisfy the GAAP criteria for bill and hold accounting. By improperly applying bill and hold accounting to certain F-term orders, the company prematurely recognized revenue on many of these transactions.

13. In 2004, at the direction of management, McKenna directed Diebold employees to ship certain F-term orders from factory to warehouse prior to the shipment dates agreed to with customers. This practice was known at the company as "pulling in" F-term orders. The amount of F-term orders "pulled in" varied by quarter, but in many instances was done purposely to inflate earnings in order to meet forecasts. For example, at the end of the second quarter of 2004, the company "pulled in" approximately $3.4 million in orders that were not scheduled to ship until the following quarter, and in the fourth quarter of 2004 the company "pulled in" approximately $3.8 million in orders that were not scheduled to ship until the following year. This improper practice inflated Diebold's earnings in those quarters by approximately $1.1 million and $1.3 million, respectively.

14. As a result of changes in the company's revenue recognition practices in 2004, fewer orders were being designated as F-term orders, and thus less revenue was being recognized. As a result, by the third-quarter of 2004, the company was not on track to meet earnings forecasts. At the direction of senior management to close the gap, McKenna made an $18.8 million top-level journal entry that pulled in revenue that would not have been recognized until subsequent quarters under its new practices. As a result of this improper entry, Diebold met its revised earnings forecast in the third quarter of 2004.

15. As a result of the conduct described above, McKenna caused Diebold's violations of Section 13(b)(2)(A) of the Exchange Act, which requires Commission registrants to make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the registrant.

16. As a result of the conduct described above, McKenna violated Rule 13b2-1 of the Exchange Act, which states that no person shall, directly or indirectly, falsify or cause to be falsified, any book, record or account subject to section 13(b)(2)(A) of the Exchange Act.

## Cooperation

17. McKenna entered into a cooperation agreement with the Division of Enforcement on April 19, 2010, in connection with the Commission's investigation of violations of the federal securities laws at Diebold and related enforcement proceedings. As a result of the investigation, the Commission filed the following enforcement actions, all of which are now concluded:

18. On June 2, 2010, the Commission filed a settled enforcement action against Diebold in which it consented to a final judgment ordering injunctive relief and a $25 million civil penalty. *See SEC v. Diebold, Inc.*, Civ. Action No. 1:10-CV-00908 (D.D.C.) / Lit. Rel. No. 21543.

19. On June 2, 2010, the Commission filed a settled compensation claw-back action against Walden O'Dell, Diebold's former CEO and Chairman, pursuant to Section 304 of the

Sarbanes-Oxley Act of 2002, in which he consented to a final judgment ordering him to reimburse $470,016 in cash bonuses, 30,000 shares of Diebold stock, and stock options for 85,000 shares of Diebold stock. *See SEC. v. O'Dell*, Civ. Action No. 1:10-CV-00909 (D.D.C.) / Lit. Rel. No. 21543.

20. On June 2, 2010, the Commission filed a contested enforcement action against Gregory Geswein, Diebold's former CFO. On May 26, 2015, pursuant to a settlement, the court entered a final consent decree against Geswein ordering him to pay $680,000 in disgorgement, a $170,000 civil penalty, and prohibiting him for three years from acting as an officer or director of a public company. *See SEC v. Geswein, et al.*, Civ. Action No. 5:10-CV-01235 (N.D. Ohio) / Lit. Rel. Nos. 21543 and 23268.

21. On June 2, 2010, the Commission filed a contested enforcement action against Kevin Krakora, Diebold's former Controller and later CFO. On May 26, 2015, pursuant to a settlement, the court entered a final consent decree against Krakora ordering him to pay $400,000 in disgorgement, a $100,000 civil penalty, prohibiting him for three years from acting as an officer or director of a public company, and prohibiting him from appearing or practicing before the Commission as an accountant, with a right to apply for reinstatement after three years. *See SEC v. Geswein, et al.*, Civ. Action No. 5:10-CV-01235 (N.D. Ohio) / Lit. Rel. Nos. 21543 and 23268.

22. On June 2, 2010, the Commission filed a contested enforcement action against Sandra Miller, Diebold's former Director of Corporate Accounting. On May 26, 2015, pursuant to a settlement, the court entered a final consent decree against Miller that permanently enjoins her from aiding and abetting any violation of Section 13(a), Section 13(b)(2)(A), and Section 13(b)(2)(B) of the Exchange Act, and Rules 13a-1, 13a-11, 13a-13, and 12b-20 thereunder, and ordered disgorgement of $29,057, which was waived, and no penalty imposed, based on her financial condition. *See SEC v. Geswein, et al.*, Civ. Action No. 5:10-CV-01235 (N.D. Ohio) / Lit. Rel. Nos. 21543 and 23268.

23. McKenna provided significant cooperation in connection with the Commission's investigation of this matter and its related enforcement actions.

## IV.

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

Accordingly, pursuant to Section 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent McKenna cease and desist from committing or causing any violations and any future violations of Section 13(b)(2)(A) of the Exchange Act, and Rule 13b2-1 thereunder.

B. Respondent shall pay disgorgement of $42,700 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to SEC

Rule of Practice 600. Payment shall be made in the following installments: (1) $21,350 due no later than ten days after the entry of this Order; and (2) $21,350, plus interest pursuant to Rule 600 of the Commission's Rules of Practice, due no later than one year after the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of disgorgement, plus any additional interest accrued pursuant to SEC Rule of Practice 600, shall be due and payable immediately, without further application.

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 Michael McKenna 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 Brian O. Quinn, Assistant Director, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549.

C. Respondent acknowledges that the Commission is not imposing a civil penalty based upon his agreement to cooperate in a Commission investigation and related enforcement action. If at any time following the entry of the Order, the Division of Enforcement ("Division") obtains information indicating that Respondent knowingly provided materially false or misleading information or materials to the Commission or in a related proceeding, the Division may, at its sole discretion and with prior notice to the Respondent, petition the Commission to reopen this matter and seek an order directing that the Respondent pay a civil money penalty. Respondent may contest by way of defense in any resulting administrative proceeding whether he knowingly provided materially false or misleading information, but may not: (1) contest the findings in the Order; or (2) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-76641; File No. SR-OCC-2015-805)

December 14, 2015

Self-Regulatory Organizations; The Options Clearing Corporation; Notice of Filing of an Advance Notice, as Modified by Amendment Nos. 1, 2 and 3, Concerning The Options Clearing Corporation's Non-Bank Liquidity Facility

Pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the Payment, Clearing, and Settlement Supervision Act of 2010 ("Payment, Clearing and Settlement Supervision Act")[1] and Rule 19b-4(n)(1)(i) under the Securities Exchange Act of 1934 ("Act"),[2] notice is hereby given that on November 5, 2015, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") an advance notice described in Items I and II below, which Items have been prepared by OCC. On November 11, 2015, OCC filed Amendment No.1 to the advance notice, which amended and replaced in its entirety the advance notice as originally submitted on November 5, 2015. On November 17, 2005, OCC filed Amendment No. 2 to the advance notice, which partially amended the advance notice as submitted on November 11, 2015. On November 24, 2015, OCC filed Amendment No. 3 to the advance notice, which amends and replaces in its entirety the advance notice as submitted on November 11, 2015, and amended on November 17, 2015. The Commission is publishing this notice to solicit comments on the advance notice from interested persons.

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

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

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

As discussed in more detail below, this advance notice is filed by OCC in connection with a proposed change to: (i) extend the existing confirmation ("Existing Confirmation")[3] for one year under the Master Repurchase Agreement ("MRA") with the same terms and conditions; (ii) enter into a second confirmation ("Second Confirmation," and collectively with the Existing Confirmation, "Confirmations") under the MRA also on the same terms and conditions except with an expiration date in June 2016; and (iii) maintain, between the Existing Confirmation and Second Confirmation, an aggregate commitment amount of no less than $1 billion and no greater than $1.5 billion under the non-bank liquidity facility ("Non-Bank Liquidity Facility") with the existing institutional investor ("Counterparty") and its agent.[4]

By this notice, OCC requests that the Commission not object to the foregoing proposed changes for renewing, in the future, the Existing Confirmation and the Second Confirmation on the same terms and conditions[5] with the same Counterparty without

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[3] The Existing Confirmation is the original $1 billion Master Confirmation executed under the Master Repurchase Agreement as described in Securities Exchange Act Release No. 73979 (January 2, 2015), 80 FR 1062 (January 8, 2015) (SR-OCC-2014-809).

[4] OCC intends the commitment amount of the Second Confirmation to be $500 million and the commitment amount of the extended Existing Confirmation to be $500 million. OCC would have the flexibility to change the commitment amount of each Confirmation at each renewal provided that at all times OCC would maintain the aggregate commitment level between the two Confirmations under the Non-Bank Liquidity Facility at no less than $1 billion and no greater than $1.5 billion. The MRA and any effective Confirmation(s) constitute the Non-Bank Liquidity Facility.

[5] For the purposes of clarity, OCC would not consider changes to the costs of entering into a Confirmation, or the rate of a transaction permitted under a Confirmation, a change to a term or condition that would require the filing of a

filing an advance notice concerning the renewal, provided that there has been no negative change to the Counterparty's credit profile or the Counterparty has not experienced a material adverse change (as defined below) since entering into the Confirmations or the latest renewal of the either Confirmation, whichever is later.

## 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 and B below, of the most significant aspects of these statements.

### (A) 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 with respect to the advance notice and none have been received.

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subsequent advance notice filing provide that such costs or rate is at the then prevailing market rate.

(B) Advance Notice Filed Pursuant to Section 806(e) of the Payment, Clearing and Settlement Supervision Act

This Amendment No. 3 to SR-OCC-2015-805 ("Filing") amends and replaces in its entirety the Filing as originally submitted on November 5, 2015, and amended on November 11, 2015 and November 17, 2015. The purpose of this Amendment No. 3 to the Filing is to clarify the conditions under which OCC would be permitted to renew either of the Confirmations without filing a subsequent advance notice filing.

***Description of Change***

This advance notice is filed by OCC in connection with a proposed change to: (i) extend the Existing Confirmation, for one year under the MRA, with the same terms and conditions, for a commitment amount of $500 million; (ii) enter into a Second Confirmation under the MRA, also on the same terms and conditions, except with an expiration date in June 2016, for a commitment amount of $500 million; and, (iii) maintain, between the Existing Confirmation and Second Confirmation, an aggregate commitment amount of no less than $1 billion and no greater than $1.5 billion under the Non-Bank Liquidity Facility with the existing Counterparty and its agent.[6] The Second Confirmation has the same terms, conditions, operations, and mechanics as the Existing Confirmation, except for the expiration date and commitment amount.

*Background*

OCC's overall liquidity plan provides it with access to a diverse set of liquidity funding sources, which include bank borrowing arrangements (i.e., OCC's syndicated

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6 The substantive terms regarding each additional transaction are set forth in the OCC Committed Repo Program Summary of Indicative Terms, which are attached hereto as Exhibits 3A and 3B. Such exhibits are non-public documents for which OCC has submitted a request for confidential treatment to the Commission.

credit facility[7]) and the Non-Bank Liquidity Facility. The Non-Bank Liquidity Facility is designed to reduce the concentration of OCC's counterparty exposure with respect to its overall liquidity plan by diversifying its lender base among banks and non-bank, non-clearing member institutional investors, such as pension funds or insurance companies.

The currently approved Non-Bank Liquidity Facility is comprised of two parts: the MRA and the Existing Confirmation, which contains certain individualized terms and conditions of transactions executed between OCC, an institutional investor and its agent. The MRA is structured like a typical repurchase arrangement in which the buyer (i.e., the Counterparty) would purchase from OCC, from time to time, United States government securities ("Eligible Securities").[8]

OCC, as the seller, would transfer Eligible Securities to the buyer in exchange for a payment by the buyer to OCC in immediately available funds ("Purchase Price"). The buyer would simultaneously agree to transfer the purchased securities back to OCC at a specified later date ("Repurchase Date") or on OCC's demand against the transfer of funds by OCC to the buyer in an amount equal to the outstanding Purchase Price plus the accrued and unpaid price differential (together, "Repurchase Price"), which is the interest component of the Repurchase Price.

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7 See Securities Exchange Act Release No. 76062 (October 1, 2015), 80 FR 64028 (October 22, 2015) (SR-OCC-2015-803).

8 OCC would use U.S. government securities that are included in clearing fund contributions by clearing members and margin deposits of any clearing member that has been suspended by OCC for the repurchase arrangements. Article VIII, Section 5(e) of OCC's By-Laws and OCC Rule 1104(b) authorize OCC to obtain funds from third parties through securities repurchases using these sources. The officers who may exercise this authority include the Executive Chairman and the President.

The Confirmations establish tailored provisions of the actual repurchase transactions permitted under the MRA. By entering into the Confirmation, the Counterparty is obligated to enter repurchase transactions even if OCC experiences a material adverse change,[9] funds must be made available to OCC within 60 minutes of OCC's delivering eligible securities, and the institutional investor is not permitted to rehypothecate purchased securities.[10] Additionally, the Confirmations set forth the terms and maximum dollar amounts of the transaction permitted under the MRA.

*Extension of the Existing Confirmation*

In order to provide continued access to liquidity resources, OCC is also proposing to extend the Existing Confirmation under the Non-Bank Liquidity Facility. The extended Existing Confirmation would have the same terms, conditions, operations, and mechanics as the Existing Confirmation entered into under the Non-Bank Liquidity Facility, but for the expiration date, which would be January 2017, and the commitment amount, which would be $500 million.[11]

The extended Existing Confirmation would, for example, continue to state that OCC is entitled to receive funds from the Non-Bank Liquidity Facility within 60 minutes of a request for such monies and delivery of eligible securities. The buyer would not be able to rehypothocate eligible securities sold to it in connection with a Non-Bank

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9 When included in a contract, a "material adverse change" is typically defined as a change that would have a materially adverse effect on the business or financial condition of a company.

10 See Securities Exchange Act Release No. 73979 (January 2, 2015), 80 FR 1062 (January 8, 2015) (SR-OCC-2014-809).

11 See Securities Exchange Act Release No. 73979 (January 2, 2015), 80 FR 1062 (January 8, 2015) (SR-OCC-2014-809).

Liquidity Facility transaction, and OCC would be able to substitute eligible securities held by the buyer. Additionally, OCC would have early termination rights with respect to any transaction entered into under the Non-Bank Liquidity Facility as well as have additional remedies in the case of "material adverse changes" to OCC. For example, OCC would require that it would not be an event of default if OCC suffers a material adverse change, such as the failure of a clearing member. This provision is important because it provides OCC with certainty of funding, even in adverse or difficult market conditions. This commitment to provide funding would be a key distinction from ordinary repurchase arrangements and a key requirement for OCC.

*Second Confirmation*

OCC proposes to enter into the Second Confirmation that would permit transactions of up to $500 million and would expire in June 2016. The proposed Second Confirmation would have the same terms, conditions, operations, and mechanics as the Existing Confirmation of the Non-Bank Liquidity Facility, but for the commitment amount and the term.

The proposed Second Confirmation, with a June 2016 expiration date, would help ensure continued access to a minimum amount of liquidity to OCC by staggering the expiration of the committed liquidity funding sources. OCC's current committed liquidity funding sources, which are its syndicated credit facility[12] and the Existing Confirmation, currently expire each year in October and January, respectively. Staggering the expiration dates of Confirmations under the Non-Bank Liquidity Facility in relationship to each other and in relationship to the other liquidity funding source in

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12 See Securities Exchange Act Release No. 76062 (October 1, 2015), 80 FR 64028 (October 22, 2015) (SR-OCC-2015-803).

OCC's overall liquidity plan would mitigate the risk of a precipitous decrease in OCC's access to liquidity as a result of a an unsuccessful renewal of any one funding source.

*Aggregate Commitment Amount under the Non-Bank Liquidity Facility*

OCC's current aggregate committed funding available under its Non-Bank Liquidity Facility ($1.0 billion) and its bank syndicated credit facility ($2.0 billion) is $3.0 billion. OCC is proposing to maintain the aggregate commitment amount under the Non-Bank Liquidity Facility at no lower than $1.0 billion and no higher than $1.5 billion, so that the aggregate total funding available is between $3.0 billion and $3.5 billion. This would provide OCC with the flexibility to: (i) react to shifting liquidity needs in a swift manner within funding parameters approved by the Commission, and (ii) reallocate the amount of funding available under the Confirmations at the time either of the Confirmations is to be renewed to manage liquidity needs and enhance its ability to ensure continual liquidity resources.

OCC would continue to evaluate the aggregate commitment amount of the Non-Bank Liquidity Facility so that OCC's available liquidity resources remain properly calibrated to its activities and settlement obligations, and to the extent: (i) OCC determines its liquidity needs merit funding levels below the $1.0 billion or above the $1.5 billion thresholds for the Non-Bank Liquidity Facility, (ii) OCC should seek to change the terms and conditions of the Non-Bank Liquidity Facility, or (iii) the Counterparty has experienced a negative change to its credit profile or a material adverse change since entering into the Confirmations or the latest renewal of the either Confirmation, OCC would submit a proposal with the Commission for approval first.

*Anticipated Effect on and Management of Risk*

Completing timely settlement is a key aspect of OCC's role as a clearing agency performing central counterparty services. The extension of the Existing Confirmation would continue to promote the reduction of risks to OCC, its clearing members and the options market in general because it would allow OCC to continue to obtain short-term funds from the Non-Bank Liquidity Facility to address liquidity demands arising out of the default or suspension of a clearing member, in anticipation of a potential default or suspension of clearing members, or the insolvency of a bank or another securities or commodities clearing organization.

The Second Confirmation and the ability to seek an aggregate commitment amount under the Non-Bank Liquidity Facility for no lower than $1.0 billion and no greater than $1.5 billion would also help OCC ensure the continued availability of its liquidity resources by embedding the staggered expiration of the committed liquidity funding sources and providing OCC with the flexibility to seek additional funding amounts at the same terms, conditions, operations, and mechanics of the Confirmations.

The MRA, like any liquidity source, would involve certain risks, but OCC would continue to structure the Non-Bank Liquidity Facility to mitigate those risks. Most of these risks are standard in any master repurchase agreement. For example, a buyer could fail to deliver, or delay in delivering, purchased securities to OCC by the applicable Repurchase Date. OCC will address this risk by seeking a security interest from the buyer in that portion of the purchased securities representing the excess of the market value over the Repurchase Price, or by obtaining other comfort from the buyer that the purchased securities will be timely returned. Further, the purchased securities generally will not be "on-the-run" securities, i.e., the most recently issued Treasury securities. The demand in the marketplace for Treasury securities, for uses other than collateral, is much greater for on-the-run Treasury securities, and, therefore, OCC believes buyers will have little incentive to retain the securities transferred by OCC.

The mechanics under the MRA would be structured so that OCC could avoid losses by paying the Repurchase Price. For example, OCC will have optional early termination rights in each Confirmation, under which OCC would be able to accelerate the Repurchase Date of any transaction by providing written notice to the buyer and paying the Repurchase Price. Through this mechanism, OCC can maintain the benefit of the MRA, while mitigating any risk associated with a particular transaction.

The MRA would be structured to avoid potential third-party risks, which are typical of repurchase arrangements. The prohibition on buyer rehypothecation and use of purchased securities, along with OCC's visibility into the buyer's custody account, would reduce the risk to OCC of a buyer default.

As with any repurchase arrangement, OCC is subject to the risk that it may have to terminate existing transactions and accelerate the applicable Repurchase Date with respect to a buyer due to changes in the financial health or performance of the buyer. Terminating transactions could negatively affect OCC's liquidity position. However, any negative effect is reduced by the fact that OCC maintains a number of different financing arrangements, and thus will have access to liquidity sources in the event the MRA is no longer a viable source.

Under the MRA, OCC would be obligated to transfer additional cash or securities as margin in the event the market value of any purchased securities decreases. OCC seeks to ensure it can meet any such obligation by monitoring the value of the purchased securities and maintaining adequate cash resources to make any required payments. Such payments are expected to be small in comparison to the total amount of cash received for each transfer of purchased securities.

The proposed change would help OCC minimize losses in the event of a default, suspension or insolvency, by allowing it to obtain funds from sources not connected to OCC's clearing members on extremely short notice to ensure clearance and settlement of transactions in options and other contracts without interruption. OCC believes that the reduced settlement risk presented by OCC resulting from the proposed change would correspondingly reduce systemic risk and promote the safety and soundness of the clearing system. The ability to borrow funds from the Non-Bank Liquidity Facility would allow OCC to avoid liquidating margin or clearing fund assets in what would likely be volatile market conditions, which would preserve funds available to cover any losses resulting from the failure of a clearing member, bank or other clearing organization.

Because the proposed change preserves substantially the same terms and conditions as the MRA and the Existing Confirmation, OCC believes that the proposed change would not otherwise affect or alter the management of risk at OCC.

***Consistency with the Payment, Clearing and Settlement Supervision Act***

OCC believes the proposed change is consistent with Section 805(b)(1) of the Payment, Clearing and Settlement Supervision Act.[13] The objectives and principles of Section 805(b)(1) of the Payment, Clearing and Settlement Supervision Act specify the

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13 12 U.S.C. 5464(b)(1).

promotion of robust risk management, promotion of safety and soundness, reduction of systemic risks, and support of the stability of the broader financial system.[14] OCC believes that the proposed change would promote these objectives because the proposed Confirmations would provide OCC with an additional source of committed liquidity to meet its settlement obligations while at the same time being structured to mitigate certain operational risks, as described above, that arise in connection with this committed liquidity source.

## III. Date of Effectiveness of the Advance Notice, and Timing for Commission Action

The proposed change may be implemented if the Commission does not object to the proposed change within 60 days of the later of (i) the date that the proposed change was filed with the Commission or (ii) the date that any additional information requested by the Commission is received. OCC 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 OCC with prompt written notice of the extension. The proposed change may be implemented in less than 60 days from the date the advance notice is filed, or the date further information requested by the Commission is received, if the Commission notifies OCC in writing that it does not object to the proposed change and authorizes OCC to implement the proposed change on an earlier date, subject to any conditions imposed by the Commission.

OCC shall post notice on its website of proposed changes that are implemented.

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14 Id.

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. 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-2015-805 on the subject line.

Paper Comments:

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

All submissions should refer to File Number SR-OCC-2015-805. 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 a.m. and 3:00 p.m. 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/components/docs/legal/rules_and_bylaws/sr_occ_15_805.pdf). 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-2015-805 and should be submitted on or before [insert date 15 days from publication in the Federal Register].

By the Commission.

Robert W. Errett
Deputy Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

**SECURITIES ACT OF 1933**
**Release No. 9991 / December 16, 2015**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76662 / December 16, 2015**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 4293 / December 16, 2015**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 31942 / December 16, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17005**

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| In the Matter of<br><br>OWEN LI and<br>CANARSIE CAPITAL, LLC<br><br>Respondents. | ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND SECTION 9(b) OF THE INVESTMENT COMPANY ACT OF 1940, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND A CEASE-AND-DESIST ORDER |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Owen Li ("Li") and Canarsie Capital, LLC ("Canarsie" and, together with Li, "Respondents").

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## 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 admit the Commission's jurisdiction over them and the subject matter of these proceedings, and consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 and Section 9(b) of the Investment Company Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

## III.

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

### Summary

1. This proceeding involves fraud and breaches of fiduciary duty by Li and Canarsie from late 2012 to January 2015, which exposed the Canarsie Capital Fund Master, LP (the "Master Fund") to the risk of significant loss and culminated in the depletion of virtually all of the Master Fund's assets in January 2015. During that period, Li was a managing member of Canarsie, a New York-based, exempt reporting adviser, and he was the portfolio manager for the Master Fund, a pooled investment vehicle advised by Canarsie.

2. Beginning in late 2012, Li made false and misleading statements and omissions to investors and potential investors concerning his personal investment in the Canarsie Capital Fund, LP (the "Onshore Fund") and omitted to inform them that he had depleted his personal assets through risky trading in his personal brokerage accounts. During 2014 and 2015, Li made false and misleading statements and omissions to investors concerning the Master Fund's performance and delays in the Master Fund's monthly performance reporting to conceal trading losses. During 2014 and 2015, Li reported fictitious trades and made other false and misleading statements and omissions to the Master Fund's prime brokers to avoid margin calls and/or to increase margin extended to the Master Fund. During 2014 and January 2015, Li traded the Master Fund's portfolio in ways that contravened the investment mandate in the Master Fund's offering memorandum.

3. In January 2015, the Master Fund collapsed after Li moved virtually the entire portfolio into long, short-dated, market index options, nearly all of which were pegged to the same

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

expiration date of January 17, 2015. When the market moved against those positions on January 16, 2015, the Master Fund was left with approximately $501,253 in cash, having started January 2015 with approximately $58 million in assets.

## Respondents

4. **Owen Li ("Li")**, age 29 and a resident of Brooklyn, New York, is a principal and managing member of Canarsie, which Li founded in 2012. Immediately after graduating from college in 2008, Li worked as a trading assistant at Galleon Management, LP ("Galleon"). Following Galleon's wind-down in 2009, Li worked as a trader for a registered investment adviser founded by a former Galleon colleague. Li left that adviser in early 2012 and formed Canarsie.

5. **Canarsie Capital, LLC ("Canarsie")**, is a Delaware limited liability company with its principal place of business in New York, New York. Canarsie, an exempt reporting adviser, is 70% owned by Li, with the remaining 30% owned by Li's two business partners (the "Partners"). Canarsie was the investment adviser for Canarsie Capital Fund Master, LP (the "Master Fund"), Canarsie Capital Fund, LP (the "Onshore Fund") and Canarsie Capital Fund Offshore, Ltd. (the "Offshore Fund") (collectively, the "Canarsie Funds"), and Canarsie had discretionary investment authority over the Canarsie Funds' assets. On January 21, 2015, Canarsie terminated its investment management agreement with the Canarsie Funds, effective as of February 20, 2015.

## Other Relevant Entities

6. **Canarsie Capital GP, LLC ("General Partner")**, is a Delaware limited liability company that acts as the general partner of the Canarsie Funds. At all relevant times, Li was the managing member and controlling person of the General Partner. On January 21, 2015, the General Partner gave written notice of its resignation, which became effective on February 20, 2015.

7. **Canarsie Capital Fund Master, LP (the "Master Fund")**, is a Cayman Islands exempted limited partnership formed in July 2013 as a "master-feeder" structure. The Master Fund has two limited partners, or feeder funds: the Onshore Fund and the Offshore Fund. The Master Fund paid Canarsie an annual management fee of 2% of its net assets, and a performance fee of 20% of the fund's net income, subject to a high-water mark.

8. **Canarsie Capital Fund, LP (the "Onshore Fund")**, is a Delaware limited partnership and pooled investment vehicle, which began offering limited partnership interests on January 1, 2013. The Onshore Fund does not have a board of directors or governance body. In August 2013, the Onshore Fund invested (and then continued to invest) substantially all of its assets in the Master Fund. At the time of the collapse in January 2015, the Onshore Fund had 41 investors.

9. **Canarsie Capital Fund Offshore, Ltd. (the "Offshore Fund")**, is a Cayman Islands exempted company formed in August 2013 for the purpose of investing substantially all of

its assets in the Master Fund. The Offshore Fund has a board of directors comprised of Li and his two Partners. At the time of the collapse in January 2015, the Offshore Fund had 6 investors.

## **Background**

10. In late 2012, Li and one of his Partners formed Canarsie and created the Onshore Fund, which launched in January 2013, with ten investors investing a total of $16.55 million. In August 2013, the Master Fund and Offshore Fund were created, as part of a master-feeder structure, and the Onshore Fund's investments were invested in the Master Fund.

11. The Master Fund ended 2013 with a year-to-date performance return of 69%, and approximately $47.75 million in assets under management (AUM). During 2013 and 2014, Canarsie earned $1,032,532 in management fees. Li's portion of Canarsie's earned performance fees for 2013 was $2,226,602, which he received. During 2014, Li earned $120,000 in salary. The Master Fund ended 2014 with approximately $58 million in AUM. When the Master Fund collapsed in January 2015, it had a total of 41 investors who, collectively and since the Fund's inception, had invested approximately $52.1 million into the Master Fund.

### ***Li Induced Investors to Invest in Canarsie Onshore Fund <u>With Material Misrepresentations and Omissions</u>***

12. In or around late 2012, Li misled certain prospective investors about his own investment in the Onshore Fund. Specifically, Li falsely told at least three prospective investors— all of whom later invested— that Li was investing his own money in the Onshore Fund.[2] At the time, Li had virtually no personal assets, having lost nearly all of his earnings from his prior employer through his personal trading during 2012. Li did not inform any of the prospective investors about these losses.

13. In a meeting in December 2012, Li told one prospective investor that he would manage the Onshore Fund's long/short portfolio in a conservative manner, managing risk through hedging and using index options only to hedge positions—in other words, he would only rarely make directional bets using market index options. The following month, that prospective investor invested approximately $7.5 million in the Onshore Fund.

14. The Canarsie Funds' offering memoranda ("Offering Memos") gave Canarsie broad discretion to trade a wide variety of securities and financial instruments, including options. The Offering Memos further stated, however, that the Master Fund's portfolio would be balanced, and that risk would be managed "through limits on position sizing and market exposure." Generally, no position, whether long or short, was to exceed 10% of the fund's assets. The Offering Memos stated that Canarsie "has internal controls in place to prevent trade errors from occurring." In the event of a trade error, the Offering Memos provided that Canarsie would use

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[2] Li did not invest any of his own money into the Canarsie Funds until January 2014, when he invested $527,843 of the performance fees he earned during 2013.

reasonable efforts to correct the error and would "endeavor to maintain a record of each trade error, including information about the trade and how such error was corrected or attempted to be corrected."

15. Beginning in February 2014, Li began to build the Master Fund's equity positions in Facebook, Groupon and IWM. By February 28, 2014, the Master Fund's equity position in these three issuers respectively comprised 20%, 23% and 19% of the Master Fund's total equity position. During March 2014, Li increased the Master Fund's equity positions in Facebook and Groupon to 27% and 28% of total equity, respectively. These concentrated positions were inconsistent with the risk management guidelines in the Offering Memos and increased the risk of loss for the Master Fund and its investors.

***Li Circumvented Canarsie's Order Management System***
***<u>to Conceal Certain Trades from Others at Canarsie</u>***

16. During the relevant period, Canarsie used an internal order management system ("OMS"), supplied by an outside vendor. Canarsie used the OMS to internally track all trades made in the Onshore Fund's and later, the Master Fund's accounts, as well as the Canarsie Funds' positions. Beginning in mid-2014, Canarsie began using the data in the OMS to calculate the Master Fund's portfolio metrics. A Canarsie employee internally circulated daily "end of day" ("EOD") emails detailing the Master Fund's profit and loss, total number of trades that day, and calculations of gross and net portfolio exposure—all of which were derived from OMS data.

17. On multiple occasions from approximately April 2013 through January 2015, Li manually deleted certain trades from Canarsie's OMS to conceal such trades from others at Canarsie.

18. In April 2013, an operations assistant who worked at Canarsie discovered a discrepancy between the Onshore Fund's positions as reflected in Canarsie's online prime brokerage account and as reflected in the OMS. The operations assistant demanded that Li begin copying him on all daily emails from brokers recapping trades so that he could confirm the Onshore Fund's trading activity. The following week, on April 25, 2013, Li terminated the operations assistant.

19. Later, in December 2014 and January 2015, Li began purchasing large amounts of market index call options. Li reported these index options to Canarsie's prime broker, but concealed the trades from others at Canarsie by intentionally not recording them into Canarsie's OMS.

***Li Reported Fictitious Trades and Made Misleading Statements and Omissions to***
***<u>Canarsie's Prime Brokers to Avoid Margin Calls and to Obtain Additional Margin</u>***

20. In March and April 2014, Li began reporting fictitious "sell" trades to Canarsie's prime broker at that time ("Prime Broker A"), as if Canarsie had executed these trades when, in fact, as Li knew, Canarsie had not. Specifically, during this time, Li engaged in a pattern of

reporting "sell" trades to Prime Broker A, and then subsequently cancelling the trades before they were to settle, which would otherwise have occurred three trading days later.

21. As Li knew, Prime Broker A calculated Canarsie's margin requirement on a trade-date, and not a settlement-date, basis. Because Li cancelled the fictitious "sells" before their settlement dates, the actual size of the Master Fund's positions was evident only on settlement date. Li's pattern of reporting and then cancelling "sell" trades created the false appearance on the trade date that Canarsie's long positions in certain stocks (and thus the margin in the account) were decreasing. This concealed risk in the portfolio, avoided a margin call from Prime Broker A, and permitted the Master Fund to avail itself of more margin from Prime Broker A than it otherwise would have extended to the Master Fund.

22. During March 2014, Li substantially increased the Master Fund's leverage. On March 1, the Master Fund's account at Prime Broker A had a margin balance of approximately $41.6 million. On March 31 into the start of April, the Master Fund's margin balance had increased to approximately $377 million, which implies leverage in excess of 6 times.

23. On or around April 8-9, 2014, Li delayed reporting to Prime Broker A certain "buy" trades and certain market index exchange traded funds that had actually been executed (through brokers other than Prime Broker A). Had Li timely reported these trades, which were based on margin, on each trade execution date, Prime Broker A would have reduced the margin available to the Master Fund.

24. Li also made false and misleading statements to another of Canarsie's prime brokers ("Prime Broker B") regarding the existence of short positions in the Master Fund's account. On October 14, 2014, Prime Broker B made a margin call of $2,314,682 on the Master Fund's account (approximately 3.7% of the Master Fund's total assets). Li satisfied the margin call by transferring $20 million from the Master Fund's account at Prime Broker A to its account at Prime Broker B. Li falsely told Prime Broker B that all of the Master Fund's hedging short positions were held at Prime Broker A. In fact, the Master Fund's account at Prime Broker A had virtually no short positions at that time.

25. Li also intentionally misreported trades to Prime Broker B in efforts to forestall margin calls and create the false appearance that the account had less leverage than it did. On October 17, 2014, Prime Broker B informed Li that the portfolio had "illogical" positions. Li falsely told Prime Broker B that he had placed two "sell" trades with an executing broker, dated October 13, 2014 (one day before the margin call), but canceled them because, according to Li, the executing broker did not have delivery instructions for Prime Broker B, and had incorrectly delivered the trades to Prime Broker A. This had not occurred, which Li knew.

26. In December 2014 and again in January 2015, Prime Broker B's risk managers contacted Li after observing heavy losses and high intra-day trading activity in the Master Fund's account. In each instance, Li falsely told Prime Broker B that hedging positions existed at Prime Broker A and that he would transfer those positions to the Fund's account at Prime Broker B to balance the portfolio. In fact, as Li knew, there were no hedging positions at Prime Broker A. At

this time, the only asset remaining in the account at Prime Broker A was approximately $25,000 in cash.

27. On January 13-15, 2015, on seven separate occasions, Li intentionally misrepresented the price or the buy/sell terms of certain options trades reported to Prime Broker B. In each instance, Li knew Canarsie's trade reports contained false information. Li later corrected the trade reports. The purpose and effect of these "cancel/correct" trades was to temporarily obscure from Prime Broker B the true extent of leverage in the account, and to create the false appearance of a less risky portfolio.

***At Prime Broker A's Insistence, Canarsie Retained a Consultant to Recommend Best Practices, But Failed to Implement the Recommendations***

28. On or around April 9, 2014, Prime Broker A discovered that in March and early April 2014, on multiple occasions, Canarsie had reported certain trades in Facebook and certain other stocks that had not, in fact, been executed. On the morning of April 10, 2014, three senior managers from Prime Broker A visited Canarsie's offices to review the unusual pattern of trading by Li and to confirm all current positions in the account by verifying each trade with executing brokers. During this process, Prime Broker A learned that a certain executing broker had no knowledge of an order reported to Prime Broker A by Li and that certain other executing brokers had received "sell" limit orders from Li but had not yet confirmed execution of these orders by the time Li reported them to Prime Broker A. Li acknowledged to Prime Broker A that some of these reported sales were, in fact, only "sell" limit orders, and not executed trades.

29. On April 10, 2014, Prime Broker A instructed Li to begin liquidating positions to decrease the Master Fund's market risk and exposure and reduce leverage in the account. On April 10, the Master Fund sold approximately $156 million worth of securities, including approximately $70 million worth of Facebook stock. Prime Broker A also placed trading restrictions on Canarsie, requiring a reduction in exposure of the Master Fund, withdrawing all margin to Canarsie, and not permitting trades to be executed away from Prime Broker A.

30. On April 21, 2014, Prime Broker A sent a letter to Canarsie, stating that it was "imperative" that misreported trade activity from Canarsie not happen again and required Canarsie to, among other things, "hire an experienced control person who is independent of the trader and who can verify the activity in the trader's book compared to the activity reported by the brokers with whom you have executed trades" and "retain a consultant to review your processes and control (the results of which review you will also provide to us)." Prime Broker A also told Canarsie it would retain trading restrictions against Canarsie, e.g., no margin would be extended to Canarsie, day trades would not be permitted without sufficient capital set aside to fully cover the risk, no trades could be executed away from Prime Broker A, and options could only be exercised with capital set aside to cover the exercises in advance.

31. In or around late April 2014, at Prime Broker A's insistence, Canarsie hired a consultant (the "Consultant") to review the firm's procedures and recommend best practices. In May 2014, the Consultant issued best practice recommendations for Canarsie, including a policy

for trade reconciliations that required a trading assistant—independent of Li—to obtain, at the end of each trading day, trade execution data directly from Canarsie's executing brokers, compare that data against the file that Canarsie planned to submit to its prime broker, reconcile any differences, and submit the trade file to the prime broker. The Consultant also recommended that Canarsie add at least one additional prime broker.

32. On May 14, 2014, Canarsie's Chief Operating Officer and the Consultant met with senior management at Prime Broker A and presented a draft of the Consultant's written report and best practice recommendations. Prime Broker A's Chief Risk Officer informed them that Prime Broker A would not lift the previously-imposed margin and trading restrictions and that Prime Broker A expected Canarsie to transition to a new prime broker.

33. Canarsie failed to implement all of the Consultant's best practice recommendations. For example, while Canarsie did eventually move to a new prime broker in fall 2014, once the new prime brokerage account was operational, Canarsie executed only closing transactions in the Prime Broker A account and eventually transferred all but $25,000 of the account balance to the new prime broker; thus, Canarsie effectively never added a second prime broker.[3] Notwithstanding the Consultant's specific recommendations to do so, Canarsie also did not enhance monitoring of Li's trading activities, implement intra-day trade reconciliations, develop procedures to address key person risk, or obtain compliance support.

34. Most significantly, Canarsie's implementation of the Consultant's recommended trade reconciliation process failed in several respects to achieve the objectives of segregating the trade reconciliation process from Li. The trading assistant depended on Li to show him executing broker trade confirmations, and the trading assistant had little or no independent communications with those executing brokers. Thus, there was no independent reconciliation of Li's trade activity, and Li could and did conceal trades by omitting the trades from Canarsie's OMS, concealing broker confirmations from the trading assistant, adding trades to the trade file after the trading assistant had finished his work but before submitting the trade file to the prime broker, and reconciling trade breaks himself.

***Li Made Material Misstatements and Omissions to Investors***
***<u>About the Master Fund's Performance</u>***

35. At or around the end of each month, Li and his Partners prepared and sent emails to Onshore and Offshore Fund investors they each brought in, respectively, describing the Master Fund's performance and containing an estimated NAV and monthly return. The estimated NAVs and monthly returns used in the emails, including emails sent by his Partners, were either supplied by Li or calculated by one of his Partners based upon data in the OMS.

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3 On June 25, 2014, Li met with representatives of Prime Broker B to discuss establishing a prime brokerage relationship. Li did not inform Prime Broker B that Prime Broker A had terminated its relationship with Canarsie, the reasons for the breakdown of Canarsie's relationship with Prime Broker A, or that Prime Broker A had withdrawn Canarsie's margin.

36. After Li and his Partners had sent their emails to investors, the Canarsie Funds' administrator (the "Administrator") emailed each investor monthly account statements showing the actual value of their investment and the fund's NAV.

37. In two instances, the estimated NAV supplied by Li and emailed to investors differed materially from the Administrator's NAV, which appeared in the investors' monthly statements. In both instances, Li: (i) misrepresented the estimated NAV to investors; (ii) intentionally delayed the Administrator's release of the NAV to investors; and (iii) made statements he knew were false and misleading to investors and to his Partners to explain away the delayed NAVs and the discrepancies between the estimated NAV and the Administrator's NAV.

*The April 2014 NAV*

38. In April 2014, the Master Fund suffered significant losses from: (i) the forced liquidation of $156 million worth of securities on April 10 by Prime Broker A; (ii) the trading restrictions imposed by Prime Broker A; and (iii) widespread volatility in the trading markets during April 2014. On April 30, 2014, the Master Fund had approximately $46.5 million in AUM, having begun the month with approximately $60.1 million in AUM, and the Master Fund's performance was down 23% from the beginning of April. On April 30, 2014, Li falsely told an investor that the performance was down 9%.

39. On May 16, 2014, the Administrator completed its calculation of the April NAV and sent it to Li for his review and approval. Li intentionally delayed approving the NAV because the Master Fund's performance— down 23%— was significantly worse than the NAV he had reported to investors at the end of April. On May 28, 2014, knowing that May's performance was better than April's, Li asked the Administrator to combine the reports for April and May to conceal the Master Fund's losses in April.

40. In late May, Li told his Partners, who were also directors of the Offshore Fund, and a few investors that the April statements were late because the Administrator was busy implementing a change in the NAV's calculation from monthly to daily. In fact, Li knew that the reason for the delayed April statements was because Li himself had delayed releasing the April NAV to the Administrator until May's performance results had been calculated.

41. On June 16, 2014, Li forwarded the Administrator's final reports for April and May to his Partners. The performance numbers for both months varied significantly from what Li had estimated at month-end. Li represented that the Master Fund's performance for April was down 9% and May was up 1%; the Administrator calculated that April was down 23% and May was up 10%. To explain these discrepancies, Li falsely told his Partners and investors that the performance numbers calculated by the Administrator did not take into account certain month-end trades which, due to delivery issues with certain executing brokers, were not settled until the following month. Li did not tell investors that the Master Fund's prime broker had withdrawn margin and imposed other trading restrictions starting in April, that the prime broker had forced the

Master Fund to liquidate approximately $156 million in positions in a single day on April 10, or that the prime broker required Canarsie to move its business to a new prime broker.

42. On July 14, 2014, in an email sent to a prospective investor, Li falsely understated the extent of losses in March and April, stating that the Master Fund was down 15% in that time period. In fact, as Li knew, the Master Fund was down 9.3% in March and 23% in April; in other words, the Master Fund was down 32% during that time period. Li also falsely told that prospective investor that Canarsie was adding a second prime broker for "security" purposes, in light of how difficult the market had been to trade.

*The November 2014 NAV*

43. On November 28, 2014, market movements caused losses in several of the Master Fund's positions. That day, Li placed three trades with executing brokers and intentionally misreported the same trades to Prime Broker B. Also on November 28, Li emailed a certain investor that the month's performance return was +1.5%. The following day, Li informed another investor that the Master Fund was up 1% for the month.

44. On the following trading day, December 1, Prime Broker B contacted Li concerning the three trade breaks that had resulted from Li's trading the prior day. Li resolved the trade breaks by cancelling two trades and reporting the third to Prime Broker B to match the way the executing broker had reported the trade.

45. On December 9, 2014, the Administrator sent a preliminary NAV calculation to Li for his review. The next day, Li asked the Administrator to calculate the November NAV using the prime broker's month-end report and to disregard the trade cancellations made by Li on December 1. The Administrator refused, telling Li that it would not be considered a best practice or consistent with Generally Accepted Accounting Principles to disregard the corrected trades in calculating the November NAV.

46. During December 2014 and through January 8, 2015, despite repeated inquiries from the Administrator, Li delayed approving the November NAV. Li finally approved Master Fund's November NAV on January 8, 2015. During December 2014 and early January 2015, Li falsely told certain investors that the November 2014 statements were late because of staffing changes at the Administrator and the Administrator's focus on preparing for the Canarsie Funds' annual audit.

47. On January 9, 2015, Li instructed the Administrator to release the November 2014 statements to investors. Li forwarded the statements to his Partners, informing them that the November 2014 performance result was worse than the estimate they had provided to investors. Li falsely told his Partners that the reason was because the NAV did not include residual funds which Li had transferred from Prime Broker A to Prime Broker B on November 28, 2014 and which, according to Li, were not credited to the account at Prime Broker B until December.

***Li Caused Catastrophic Losses in the Master Fund Through Risky Options Trading***

48. During December 2014 and January 2015, Li concealed from investors the fact that he traded the Master Fund in contravention of the investment mandates in the Canarsie Funds' Offering Memos and that, in doing so, he had placed the Master Fund at excessive risk of catastrophic loss. Li did so by concealing his trading from Canarsie's trading assistant, who continued to circulate daily "end of day" ("EOD") emails to Li and his Partners with the Master Fund's daily performance and trading information. As a result, the performance and trading information in the Trading Assistant's EOD emails falsely represented the state of the Master Fund's portfolio.

49. During December 2014, by trading equity and options, Li reduced the Master Fund's cash position from approximately $21.3 million as of November 30, 2014 to a negative $12 million by December 31, 2014. As of December 31, 2014, the Master Fund had long positions of approximately $71.8 million and short positions of approximately $2.7 million. In contravention of the investment mandate of a portfolio of global publicly-traded equities and the risk management guidelines set forth in the Canarsie Funds' Offering Memos, the Master Fund's short positions comprised only 3.8% of the total portfolio. At year end, 81.7% of the Master Fund's portfolio was comprised of equity and 18.3% was comprised of options. The Master Fund's net equity at year-end 2014 was approximately $58 million.

50. Beginning in the first week of January 2015, Li began liquidating the Master Fund's long positions. By January 16, all the Master Fund's equity long positions had been liquidated and the Master Fund had incurred approximately $18 million in losses on equity trades.

51. Beginning on or around December 31, 2014 and continuing through January 15, 2015, Li used cash in the account and proceeds from stock sales to buy long positions in market index options. Virtually all of these purchases were in long call options with an expiration date of January 17—in other words, short-dated long options. At the same time, Li took down and eventually eliminated all short positions in the account. The result was an entirely long portfolio with no hedge.

52. On January 16, the market for index options moved against Canarsie's positions, resulting in losses of approximately $39 million (approximately $28 million in expired premium and approximately $10.5 million in trading losses), leaving the Master Fund with no equity, short or options positions, and only $211,685 in cash (plus approximately $289,568 in its bank account). As a result of Li's risky trading, Li caused the Master Fund to incur approximately $56.5 million in losses between December 31, 2014 and January 16, 2015, substantially depleting all of the Master Fund's assets.

53. On January 20, 2015, the first business day following January 16, Li sent a letter to all investors stating:

> I am writing to express my extreme sorrow and deep regret for engaging in a series of transactions over the last several weeks that have resulted in the loss of all but two hundred

thousand dollars of the Fund's capital. In an attempt to recover losses that the Fund suffered in December, I engaged in a series of aggressive transactions over the last three weeks that—generally speaking—involved options with strike prices pegged to the broader market increasing in value, but also involved some direct positions. Unfortunately, these positions rapidly declined in value over the past two weeks as the market struggled—and I was unable to mitigate the Fund's losses.

**Violations**

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

55. As a result of the conduct described above, Respondents willfully violated Sections 206(1) and 206(2) of the Advisers Act by employing devices, schemes or artifices to defraud clients, or engaging in transactions, practices or courses of business that defrauded clients or prospective clients, or which operated as a fraud or deceit upon clients or prospective clients.

56. As a result of the conduct described above, Respondents willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder, which prohibit an investment adviser from engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative; and prohibit any investment adviser to a pooled investment vehicle from making any untrue statement of a material fact or omitting to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investors or prospective investor in the pooled investment vehicle; or otherwise engaging 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.

**IV.**

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 Section 8A of the Securities Act, Section 21C of the Exchange Act, Sections 203(e), 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondents Li and Canarsie cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 206(1), 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder.

B. Respondent Canarsie is censured.

C. Respondent Li 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
>
> 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.

D. Any reapplication for association by Respondent Li 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 Li, 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.

E. Respondents Li and Canarsie shall pay, on a joint and several basis, disgorgement of $3,379,134 and prejudgment interest of $115,804 to the Securities and Exchange Commission. This disgorgement and prejudgment interest obligation shall be deemed satisfied by the restitution order in *United States v. Li*, a parallel criminal action filed in the United States District Court for the Southern District of New York, provided that Respondent Li pleads guilty and does not withdraw his guilty plea in *U.S. v. Li*. In the event Respondent Li withdraws his guilty plea in *U.S. v. Li*, he and Canarsie shall be liable, on a joint and several basis, for the full amount of disgorgement of $3,379,134, prejudgment interest of $115,804, plus any accrued interest pursuant to SEC Rule of Practice 600.

## V.

It is further Ordered that, for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary

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

Chair White
Not participating
Commissioner Piwowar
Disapproved

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

**SECURITIES ACT OF 1933**
**Release No. 9993 / December 18, 2015**

| | |
|---|---|
| **In the Matter of**<br><br>**JPMorgan Chase Bank, N.A.**<br><br>**Respondent.** | **ORDER UNDER RULE 506(d) OF THE SECURITIES ACT OF 1933 GRANTING A WAIVER OF THE RULE 506(d)(1)(iii) DISQUALIFICATION PROVISION** |

## I.

JPMorgan Chase Bank, N.A. ("JPMCB") submitted a letter dated December 11, 2015 requesting that the Securities and Exchange Commission (the "Commission") grant a waiver of disqualification under Rule 506(d)(2)(ii) of Regulation D under the Securities Act of 1933 (the "Securities Act").

## II.

On December 18, 2015, the U.S. Commodity Futures Trading Commission (the "CFTC") entered order CFTC Docket No. 16-05 (the "CFTC Order") instituting proceedings pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, making findings and imposing remedial sanctions as a result of JPMCB's failure to adequately disclose certain conflicts of interest to clients.

## III.

Rule 506(d)(2)(ii) of Regulation D provides that disqualification "shall not apply. . . 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." The Commission has determined that as part of the Rule 506(d)(2)(ii) showing of good cause, JPMCB will comply with the following:

A. Retain, at JPMCB's expense and within sixty (60) days of the issuance of this Order, a qualified independent compliance consultant (the "Consultant") not unacceptable to Commission staff. JPMCB shall require the Consultant to conduct a comprehensive review of the policies and procedures relating to compliance with Rule 506 of Regulation D by JPMCB, including but not limited to policies and procedures relating to JPMCB's activities as an investment manager and placement agent to private funds relying on Rule

506 of Regulation D, and the subsidiaries of JPMCB conducting any activities that would otherwise be disqualified pursuant to the CFTC Order (together with JPMCB, the "Rule 506 Entities").

B. Cooperate fully with the Consultant, including providing the Consultant with access to the Rule 506 Entities' files, books, records, and personnel as reasonably requested for the review, obtaining the cooperation of employees or other persons under JPMCB's control, and permitting the Consultant to engage such assistance (whether clerical, legal, technological, or of any other expert nature) as necessary to achieve the purposes of the retention.

C. Require the Consultant to complete its review and submit a written report (the "Annual Report") to JPMCB, including its principal executive officer and principal legal officer, on an annual basis for a period of five years after the issuance of this Order. JPMCB shall require that the Consultant test the Rule 506 Entities' policies and procedures relating to Rule 506 of Regulation D by conducting a statistically valid random sampling of transactions conducted in reliance on Rule 506 of Regulation D.

D. The Consultant shall certify annually in the Annual Report that JPMCB's policies and procedures designed to ensure compliance by the Rule 506 Entities with their obligations under Rule 506 of Regulation D are reasonably designed to achieve their stated purpose.

E. Require JPMCB's principal executive officer and principal legal officer to certify in writing annually that they reviewed the Annual Report and to submit a copy of the certification and the Annual Report to Commission staff for public dissemination.

F. Require the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Rule 506 Entities, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement will also provide that the Consultant will require that any firm with which the Consultant is affiliated or of which the Consultant is a member, and any person engaged to assist the Consultant in performance of the Consultant's duties under this Order shall not, without prior written consent of Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Rule 506 Entities, or any of their 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.

G. To ensure the independence of the Consultant, JPMCB shall not have the authority to terminate the Consultant without prior written approval of

Commission staff and shall compensate the Consultant and persons engaged to assist the Consultant for services rendered pursuant to this Order at their reasonable and customary rates.

H. With respect to any aspect of the Consultant's review or testing of (including recommendations relating to) policies and procedures that a Rule 506 Entity considers unduly burdensome, impractical or inappropriate, JPMCB shall propose in writing to the Consultant and the Commission staff an alternative approach designed to achieve the same objective or purpose. JPMCB and the Consultant shall attempt in good faith to reach an agreement within 30 days of such written proposal. Within 15 days after the conclusion of the discussion, JPMCB shall require that the Consultant inform JPMCB and the Commission staff in writing of the Consultant's final determination concerning any aspect of the Consultant's review, testing or recommendations that JPMCB considers to be unduly burdensome, impractical or inappropriate. JPMCB shall abide by the determination of the Consultant. For good cause shown, the Commission staff may extend any of the procedural dates relating to the conditions in this Order. 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.

**IV.**

Based on the foregoing and the facts and representations in JPMCB's request for a waiver of disqualification, and assuming that JPMCB complies with the CFTC Order and this Order, the Commission has determined that JPMCB has made a showing of good cause under Rule 506(d)(2)(ii) that it is not necessary under the circumstances to deny reliance on Rule 506 of Regulation D by reason of the entry of the CFTC Order. Any different facts from those represented or failure to comply with the terms of the CFTC Order or this Order would require us to revisit our determination that good cause has been shown and could constitute grounds to revoke or further condition the waiver. Further, for a period of five years from the date of this Order, if JPMCB is the subject of any action that triggers "ineligible issuer" status in Rule 405 of the Securities Act, disqualification under Section 9(a) of the Investment Company Act of 1940 or disqualification under Rule 506(d) of Regulation D, the Commission reserves the right, in its sole discretion, to revoke or further condition the waiver under those circumstances. In that event, JPMCB shall first be notified and have the opportunity to present to the Commission staff an analysis supporting why this waiver should not be revoked or further conditioned.

Accordingly, **IT IS ORDERED**, pursuant to Rule 506(d) of Regulation D under the Securities Act, that a waiver from the application of the disqualification provision of Rule 506(d)(1)(iii) under the Securities Act resulting from the entry of the CFTC Order is hereby granted to JPMCB.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chair White
Not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9992 / December 18, 2015

SECURITIES EXCHANGE ACT OF 1934
Release No. 76694 / December 18, 2015

INVESTMENT ADVISERS ACT OF 1940
Release No. 4295 / December 18, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-17008

In the Matter of

JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC,

Respondents.

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 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

3 of 24

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 15(b) 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 JPMorgan Chase Bank, N.A. ("JPMCB") and J.P. Morgan Securities LLC ("JPMS" and, together with JPMCB, "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. Respondents admit the facts set forth in Section III.B below, acknowledge that the conduct set forth in Section III.B violated the federal securities laws, admit the Commission's jurisdiction over them and the subject matter of these proceedings, and consent to the entry of this 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 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 Respondents' Offers, the Commission finds that:

### A. Summary

1. This matter concerns the negligent failure of JPMorgan Chase & Co.'s ("JPMorgan's") wealth management businesses, JPMorgan Chase Bank, N.A. ("JPMCB") and J.P. Morgan Securities LLC ("JPMS"), to disclose conflicts of interest arising from, as applicable, preferences for (i) JPMorgan-managed mutual funds ("Proprietary Mutual Funds"), (ii) JPMorgan-managed private hedge funds ("Proprietary Hedge Funds," and, together with Proprietary Mutual Funds, "Proprietary Funds"), and (iii) third-party-managed private hedge funds that shared client fees with a JPMCB affiliate.

2. From May 2008 to 2013, JPMS failed to disclose that it designed and operated Chase Strategic Portfolio ("CSP"), a retail unified managed account program, with a preference for Proprietary Mutual Funds. JPMS also failed to disclose that there was an economic incentive to invest CSP Assets in Proprietary Mutual Funds as a result of discounted pricing for services provided to JPMS for CSP by a JPMS affiliate. The discounts were based on the amount of CSP assets that JPMS invested in Proprietary Mutual Funds. Finally, until November 2013, JPMS failed to disclose to CSP clients the availability of certain less expensive Proprietary Mutual Fund share classes. As a result, Respondent JPMS breached its fiduciary duty to CSP clients by failing to adequately disclose conflicts of interest.

3. JPMCB likewise failed to disclose a preference for Proprietary Funds to discretionary managed account clients of two U.S.-based wealth management businesses: J.P. Morgan Private Bank ("JPM U.S. Private Bank") and Chase Private Client ("CPC"). From 2011 to 2014, JPMCB failed to disclose its preference for Proprietary Mutual Funds to JPM U.S. Private Bank clients with discretionary managed accounts and to CPC clients invested in a discretionary managed account program called J.P. Morgan Investment Portfolio. In addition, JPMCB failed to disclose to JPM U.S. Private Bank clients with discretionary managed accounts, from 2008 until 2014, its preference for Proprietary Hedge Funds and, from 2008 until August 2015, its preference for third-party-managed hedge funds that shared their management and/or performance fees with a JPMCB affiliate. As a result, Respondent JPMCB did not satisfy its disclosure duty to certain of its affluent, high net worth and ultra-high net worth clients who invested through discretionary accounts.

## Respondents

4. **JPMorgan Chase Bank, N.A. ("JPMCB")**, a wholly-owned subsidiary of JPMorgan, is a nationally-chartered bank, incorporated in 1824, and headquartered in New York, New York. JPMCB acts as the investment manager for certain discretionary portfolios offered primarily to clients of the JPM U.S. Private Bank, the marketing name for JPMorgan's U.S. business unit that provides banking and investment services to high net worth and ultra-high net worth clients. JPMCB is not registered under the Advisers Act, as it is excluded from the definition of investment adviser pursuant to Section 202(a)(11)(A) of the Advisers Act.

5. **J. P. Morgan Securities LLC ("JPMS")**, a wholly-owned subsidiary of JPMorgan, is a Delaware company headquartered in New York, New York. JPMS has been registered with the Commission as an investment adviser since 1965 and as a broker-dealer since 1985. JPMS or its affiliates[1] have offered CSP through more than 2,800 financial advisors located in Chase bank branches nationwide from CSP's launch in 2008 to the present.

## Other Relevant Entities and Lines of Business

6. **JPMorgan Chase & Co. ("JPMorgan")** is a Delaware corporation headquartered in New York, New York. JPMorgan is a global financial services firm and bank with $2.6 trillion in assets as of December 31, 2014.

7. **JPMorgan Asset Management ("JPMAM")** is one of JPMorgan's primary business units and oversees, among other businesses, JPM U.S. Private Bank and JPMorgan's Proprietary Funds business. As of December 31, 2014, JPMAM had $1.7 trillion in assets under management.

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[1] From CSP's inception in 2008 through September 2012, Chase Investment Services Corp. ("CISC"), an affiliate of JPMS that was registered as an investment adviser and broker-dealer from 1990 to 2012, offered and managed CSP. On October 1, 2012, CISC was merged into JPMS, and JPMS became the investment adviser for CSP.

8. **J.P. Morgan's U.S. Private Bank ("JPM U.S. Private Bank")** is the marketing name of a business unit within JPMAM that operates in the U.S. and provides banking and investment management services to high net worth and ultra-high net worth individuals through JPMCB. As of December 31, 2014, JPM U.S. Private Bank had approximately $207 billion in assets under management. (This excludes JPMorgan-managed funds purchased in self-directed brokerage accounts.) Hereinafter, reference to JPMCB will encompass both JPMCB and JPM U.S. Private Bank.

## B. <u>Facts</u>

9. As set out more fully below, during the relevant period, JPMS and JPMCB failed to adequately disclose certain conflicts of interest to their clients.

### <u>Chase Strategic Portfolio</u>

10. In early 2007, JPMS and JPMAM (which, among other things, oversees JPMorgan's Proprietary Funds business), began developing CSP, a unified managed account program, for distribution to retail investors through JPMS-affiliated advisors located in Chase bank branches across the country. CSP's minimum account value has always been $50,000 and its current median account value is approximately $110,000.

11. As a unified managed account program, CSP comprised a set of standardized, risk-weighted portfolios of predominantly registered funds. JPMS (or, beginning in September 2013, an affiliate of JPMS engaged to serve as sub-adviser) selected the constituent holdings for each CSP portfolio and set the percentage of assets invested in each holding in the various CSP portfolios. For example, the entry-level "Conservative" portfolio in late 2009 held 12 mutual funds, seven of which were Proprietary Mutual Funds. JPMS allocated 57% of this portfolio's assets to Proprietary Mutual Funds.

*<u>JPMS Failed to Disclose that It Preferred to Invest CSP Assets in Proprietary Mutual Funds</u>*

12. JPMS and JPMAM designed CSP with an expectation that a majority of CSP's assets would be in Proprietary Mutual Funds, as well as JPMAM-managed money market funds and separately managed accounts (together with Proprietary Mutual Funds, "Proprietary CSP Assets"). JPMAM correspondingly would benefit from the management fees earned from these allocations.

13. From approximately June 2007 to March 2008, the fund research team servicing CSP conducted quantitative and qualitative due diligence. The team first applied a quantitative scoring methodology that awarded points to potential funds based on a series of analytical metrics. It next conducted a qualitative review which, among other things, included fund manager interviews and incorporated judgments about those managers' investment philosophies. As part of its review, the fund research team exercised a preference for Proprietary Mutual Funds.

14. JPMS launched CSP in May 2008 and, consistent with an expectation that a majority of CSP's assets would be in Proprietary CSP Assets, JPMS invested approximately 60% of CSP client assets in Proprietary CSP Assets. Since that time, JPMS has continuously operated CSP with a preference for Proprietary Mutual Funds.

15. From 2008 to 2013, CSP grew rapidly and by December 2013, JPMS had invested approximately $10 billion in Proprietary Mutual Funds out of a total of $32.6 billion of CSP client mutual fund assets. From early 2009 until early 2012, JPMS invested approximately 47% to 51% of CSP client mutual fund assets in Proprietary Mutual Funds. Thereafter, the percentage began to decrease, falling to 45% by mid-2012, to approximately 31% by year-end 2013 and 27% by year-end 2014.

16. From 2008 through August 5, 2013, neither CSP's Schedule H or its successor Form ADV Part 2A (collectively, "CSP ADV") nor CSP marketing materials disclosed that JPMS preferred Proprietary Mutual Funds. JPMS also failed to disclose that JPMS and JPMAM had designed CSP to feature Proprietary Mutual Funds, that JPMS had an expectation that it would invest a majority of CSP client assets in Proprietary CSP Assets at the beginning of the program, and that JPMAM had this expectation from the beginning of the program until early 2013.

*JPMS Failed to Disclose That JPMAM Provided Discounted Services to CSP Based on the Amount of CSP Assets JPMS Invested in Proprietary CSP Assets*

17. JPMS contracted with an affiliate in JPMAM to provide various services to CSP, including "overlay services" (i.e., trading and reporting services related to the management of CSP portfolios) and, later, asset allocation, portfolio construction, and tactical trading advice.

18. JPMAM tied both its willingness to provide services to JPMS and the pricing for those services to the amount of CSP's assets that JPMS invested in Proprietary CSP Assets. Between 2008 and 2013, JPMS failed to disclose that the discounted pricing of services provided to JPMS by a JPMAM affiliate was tied to the amount of CSP assets that JPMS invested in Proprietary CSP Assets. JPMS also did not disclose for a period of time that JPMAM's provision of services to CSP was tied to JPMS's investment of the majority of CSP assets in Proprietary CSP Assets.

*JPMS Failed to Disclose the Availability of Lower Cost Share Classes*

19. When selecting mutual funds for CSP, JPMS typically negotiated with the funds' advisers regarding, among other things, the share class into which it would invest CSP clients. Different share classes have different minimum investment amounts and fee structures, but otherwise reflect an identical interest in the funds. For example, institutional share classes usually require a minimum $1 million investment and have lower distribution and shareholder servicing fees than share classes available to retail investors. The difference in fees between institutional and retail share classes is typically 65 basis points or more.

20. JPMS's CSP ADV described the share classes available in the program as follows: "Fund shares sold in [CSP] are generally investor or institutional class shares, or no load or load-waived Class A shares that are sold at net asset value." CSP clients were informed in writing prior to account opening of the share class they would be receiving and the fees associated with that share class.

21. Certain of the Proprietary Mutual Funds used in CSP offered, in addition to retail share classes, two different institutional share classes: (a) a "Select" share class (with an investment minimum of $1 million) and (b) an "Institutional" share class (with an investment minimum of $3 million). For a majority of the Proprietary Mutual Funds used in CSP, the "Select" share class was the only institutional share class offered by the fund.

22. From 2008 to 2013, a minority of the Proprietary Mutual Funds used in CSP offered both Select and Institutional classes. In certain of these funds, JPMS invested CSP client assets in the Select share class even though the lower cost Institutional class was available. The Select share class typically had a shareholder servicing fee that was 15 basis points higher than the Institutional share class offered by those Proprietary Mutual Funds. As a result, JPMAM earned higher fees when JPMS invested CSP client assets in the Select share class. In November 2013, JPMS converted all CSP client investments in Select shares to Institutional shares where the Proprietary Mutual Funds offered Institutional shares.

23. Between 2008 and 2013, JPMS failed to disclose that certain of the Proprietary Mutual Funds purchased for CSP clients offered Institutional shares that were less expensive, and would generate less revenue for a JPMS affiliate, than the Select shares JPMS chose for CSP clients.

*JPMS's Forms ADV Failed to Adequately Disclose Conflicts of Interest*

24. From May 2008 to February 2013, JPMS filed nine CSP ADVs with the Commission.

25. JPMS's CSP ADVs described the quantitative and qualitative criteria used during the fund selection process. For example, the CSP ADV dated March 2011 stated: "Both affiliated and non-affiliated [Mutual] Funds...are evaluated and monitored using the same criteria."

26. In its CSP ADV filings, JPMS disclosed certain conflicts of interest. For example, JPMS disclosed that an affiliate performed overlay services for CSP. Additionally, JPMS disclosed the conflict of interest arising from the use of Proprietary Mutual Funds. For example, the versions of the CSP Schedule H in effect in 2009 and 2010 provided that JPMS "may have a conflict of interest in including affiliated [Mutual] Funds...because [JPMS] and/or its affiliates will receive additional compensation."

27. In addition, in advance of account opening, CSP clients were informed which funds were proposed for their CSP portfolio, and how much of the portfolio's assets were to be allocated to each Proprietary Mutual Fund and each third-party mutual fund. Once the account

was open, CSP clients were informed of which funds were in their account and the amount of assets allocated to those funds through, for example, periodic account statements and client reviews. Marketing materials used with potential CSP clients also disclosed which funds were to comprise a portfolio and the amount of portfolio assets allocated to each fund.

28. However, in its CSP ADV filings, JPMS did not disclose that it had exercised a preference for Proprietary Mutual Funds in CSP. JPMS also failed to disclose that the discounted pricing of services provided to JPMS for CSP by a JPMAM affiliate was tied to the amount of CSP assets that JPMS invested in Proprietary CSP Assets. Finally, JPMS's CSP ADV filings did not disclose that, for certain of the Proprietary Mutual Funds in which it invested CSP clients, less expensive share classes were available.

29. On August 5, 2013, JPMS filed an amended CSP ADV that disclosed there "may" be a preference for Proprietary Mutual Funds in CSP. On December 31, 2013, JPMS further amended the CSP ADV to disclose that "[a]s a general matter, we prefer" Proprietary Mutual Funds.

### *JPMS Failed to Implement Written Policies and Procedures Reasonably Designed to Prevent Violations of the Advisers Act and the Rules Thereunder*

30. JPMS did not implement its written policies and procedures to ensure adequate disclosure of the conflicts of interest discussed above. From 2008 to 2012, JPMS's written policies and procedures required that JPMS avoid any actual or potential conflict of interest and that any such conflict be disclosed to clients with discretionary managed accounts. On certain occasions, the disclosure concerning the use of Proprietary Mutual Funds in CSP was raised, and discussed among JPMS personnel, but was not adequately addressed. Policies and procedures were insufficiently implemented to ensure that (a) the disclosures relating to the above conflicts of interest were sufficiently reviewed and (b) the above conflicts of interest were adequately disclosed to CSP clients. As a result, JPMS did not implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.

## JPMorgan Chase Bank, N.A.

31. JPMCB provides wealth management services to clients with three progressively higher levels of wealth: affluent, high net worth, and ultra-high net worth. Through JPM U.S. Private Bank, JPMCB serves high net worth and ultra-high net worth clients. JPMCB serves as the fiduciary investment manager for discretionary, diversified, risk-adjusted investment management accounts ("IM accounts") that can hold, among other investments, mutual funds and hedge funds.

32. JPMCB also serves as investment manager to certain private funds, known as the Global Access Portfolios ("GAP"), that offer to JPM U.S. Private Bank clients diversified portfolios comprised of, among other underlying investments, mutual funds and/or hedge funds. The GAP private funds may be held in an IM account ("GAP IM Holdings").

33. In 2007, JPMCB and JPMS jointly developed J.P. Morgan Investment Portfolio ("JPMIP"), a new managed account product to be marketed as part of a new banking and wealth management business called Chase Private Client. JPMIP was offered to affluent Chase banking clients. JPMIP accounts were identical to certain IM accounts, with investments in mutual funds, for example.

*JPMCB Failed to Disclose its Preference for Proprietary Funds*

34. JPMCB prefers Proprietary Funds in IM accounts, GAP private funds, and JPMIP and expects that a significant percentage of relevant portfolio assets will be invested in Proprietary Funds. For example, in early 2011, JPMCB had invested 47% of mutual fund assets and 35% of hedge fund assets in JPMCB IM client accounts in Proprietary Funds.

35. From December 2006 to February 2011, JPMCB disclosed its preference for Proprietary Mutual Funds in what was entitled "JPMorgan general investment principles regarding the use of JPMorgan Funds and external managers" (the "Investment Principles"). The Investment Principles were distributed to relevant clients through various means including the incorporation of the Investment Principles into the JPMorgan Fund Disclosure Statement ("FDS"), a document provided to new IM account clients (including those with GAP IM Holdings), JPMIP clients, and to clients with existing accounts in an annual mailing. In January 2011, JPMCB mistakenly removed the Investment Principles (including language stating "we prefer to use JPMorgan-affiliated managers") from the FDS while amending the FDS for reasons unrelated to the language on a preference. By January 2011, the FDS was the sole means by which the Investment Principles were being affirmatively distributed to clients on a systematic basis. Therefore, from February 2011 until January 2014, JPMCB did not disclose a preference for Proprietary Mutual Funds in account documentation.

36. JPMCB disclosed that it had a conflict of interest when it invested its clients' discretionary portfolio assets in Proprietary Funds, as such investments increased revenue to affiliates. In addition, clients were informed of which funds were in their discretionary portfolios, as well as the amount of assets held in each Proprietary Fund and third-party fund through, for example, periodic account statements and client reviews. However, during the time period of February 2011 to January 2014, no account opening documents or marketing materials disclosed to IM account clients (including those with GAP IM Holdings) or JPMIP clients that JPMCB preferred to invest client assets in Proprietary Mutual Funds.

37. With respect to those portfolios that might be invested in private hedge funds, account opening documents disclosed JPMCB's conflict of interest when investing client assets in Proprietary Hedge Funds. However, from 2008 through January 2014, JPMCB did not disclose its preference for investing IM account or GAP IM Holding assets in Proprietary Hedge Funds.

38. Beginning in January 2014, language providing that "[a]s a general matter, we prefer" Proprietary Funds was incorporated into account opening documentation, the FDS, account statements, marketing materials and other documentation used with IM account clients (including those with GAP IM Holdings) and JPMIP clients.

*JPMCB Failed to Disclose its Preference for Retrocession-Paying Third-Party Hedge Fund Managers*

39. For the IM accounts, GAP private funds, and JPMIP accounts, JPMCB uses the investment funds on what is known as the "Private Bank Platform." With respect to most of the private hedge funds on the Private Bank Platform, a broker-dealer affiliate of JPMCB acts as the placement agent and earns fees for placement, shareholder servicing and other ongoing services. These placement agent fees are typically referred to as "retrocessions" and are usually a portion of the private hedge fund managers' management and/or performance fees earned on relevant client assets. The standard retrocession that the broker-dealer affiliate of JPMCB receives from a third-party hedge fund is approximately 1.0% of the market value of relevant client assets invested, paid on an annual basis. Retrocessions are not additional fees paid by JPM U.S. Private Bank clients; rather, the retrocessions are paid by the hedge funds and/or their sponsors.

40. Beginning in at least 2005, JPMCB sought retrocessions from third-party private hedge fund managers under consideration for inclusion on the Private Bank Platform. During introductory meetings, the third-party hedge fund managers were typically asked about their willingness to pay retrocessions. If a manager declined to pay retrocessions, an alternative manager with a similar investment strategy that would pay retrocessions was typically sought. Currently all but one of the third-party-managed hedge funds on the Private Bank Platform and available for direct investment in IM accounts pay retrocessions to JPMCB affiliates.

41. JPMCB disclosed to its IM account clients (including those with GAP IM Holdings) that its affiliates may receive retrocessions in connection with investments in third-party hedge funds and informed some clients that retrocessions lowered client fees by reducing the clients' total costs to access the hedge funds on the Private Bank Platform. However, JPMCB did not disclose its preference for retrocession-paying third-party hedge fund managers in IM accounts and GAP IM Holdings until August 2015, when it added additional language to certain client documentation regarding the extent to which such funds are used in certain discretionary portfolios.

## C. Remedial Actions

42. In determining to accept Respondents' Offers, the Commission considered remedial acts promptly undertaken by Respondents and cooperation afforded the Commission staff. Respondents retained an independent compliance consultant ("ICC") to review policies and procedures concerning disclosures of conflicts of interest; the ICC has completed its review and issued recommendations; and Respondents have accepted and implemented the ICC's recommendations.

43. Respondents have agreed to provide notice of these proceedings to their JPMS and JPM U.S. Private Bank clients and prospective clients with CSP, JPMIP, and IM accounts (including IM accounts with GAP IM Holdings) ("relevant client(s)") as follows:

a. Within ninety (90) days of the date of entry of this Order, Respondents shall (1) post on their website a brief description of these proceedings in a form and location not unacceptable to Commission staff, and accessible to relevant clients, with a hyperlink to this Order and (2) provide a brief description of these proceedings with a link or hyperlink to this Order to each relevant client by mail or email, in a form not unacceptable to the Commission staff; or by such other method as may be acceptable to the Commission staff. Hyperlinks or links to the Order provided to relevant clients and on Respondents' websites shall remain active for a period of one year from the date of entry of this Order;

b. Respondent JPMS further agrees, for a period of one year from the date of entry of this Order, to the extent that it is required to deliver a brochure to a CSP client and/or prospective CSP client pursuant to Rule 204-3 of the Advisers Act, to provide a brief description of these proceedings by mail or email, with a link or hyperlink to this Order, to such CSP client at the same time that JPMS delivers the brochure.

**D. Violations**

44. As a result of the conduct described above, JPMS willfully[2] violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from, directly or indirectly, engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.

45. As a result of the conduct described above, JPMS willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and its rules.

46. As a result of the conduct described above, JPMS willfully violated Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission . . . or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

47. As a result of the conduct described above, JPMCB willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, which, respectively, prohibit making untrue statements of material fact or material omissions in the offer or sale of securities and engaging in a course of business which operates as a fraud or deceit in the offer or sale of securities.

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[2] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)). The actor may be found to have acted willfully even if, as here, the violations resulted from negligent conduct.

**IV.**

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 Section 8A of the Securities Act, Section 15(b) of the Exchange Act, and Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent JPMorgan Chase Bank, N.A. cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

B. Respondent J.P. Morgan Securities LLC 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.

C. Respondent J.P. Morgan Securities LLC is censured.

D. Respondents, jointly and severally, shall, within 14 days of the entry of this Order, pay disgorgement, which represents profits gained as a result of the conduct described herein of $127,500,000 and prejudgment interest of $11,815,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). Respondents, jointly and severally, shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of $127,500,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). 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) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondents 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) Respondents 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 JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC as Respondents 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 Valerie A. Szczepanik, Assistant Director, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, NY 10281-1022, and to Timothy Casey, Assistant Director, Legal Operations, New York Regional Office, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, NY 10281-1022, or such other person or address as the Commission staff may provide.

By the Commission.

Brent J. Fields
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. 76695 / December 18, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17009**

**In the Matter of**

**ERIC E. SHEAR,**

**Respondent.**

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

**I.**

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

**II.**

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

## III.

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

**Summary**

1. This matter involves insider trading by Respondent in the securities of Pioneer Behavioral Health, Inc. ("PHC") in advance of the May 24, 2011 announcement that Acadia Healthcare Company, Inc. ("Acadia") had agreed to acquire PHC.

2. In or around the first half of April 2011, while working at PHC, Shear learned that Pioneer was about to engage in a significant transaction. Shear knew that he had a fiduciary duty to maintain this information in confidence.

3. On April 18, 2011, Shear placed trades in a family member's brokerage account while in possession of material nonpublic information. As a result of his improper use of the insider information, Respondent generated gains of $2,968.

4. As a result of the conduct described above, Shear violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

**Respondent**

5. *Eric E. Shear*, age 53, resides in Jupiter, FL. During the relevant time, Shear was Director of Business Development at PHC and resided in Danvers, MA.

**Other Relevant Persons**

6. *Pioneer Behavioral Health, Inc.* was a Massachusetts company headquartered in Peabody, MA. It provided behavioral health services. Its common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act until after it was acquired by Acadia. PHC's common stock traded on the American Stock Exchange (former ticker symbol PHC).

7. *Acadia Healthcare Company, Inc.* is an SEC reporting company incorporated in Delaware and headquartered in Franklin, TN. It provides behavioral health services. Its common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act. Acadia's common stock is traded on NASDAQ Global Market under the ticker symbol ACHC.

8. *Individual A* is a member of Shear's family. Individual A resided in Massachusetts during the relevant time period, and currently resides in Florida. Individual A

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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.

holds an individual retirement account at a brokerage firm. Individual A provided Shear with the login and password to this IRA account, for the purpose of permitting Shear to make trades in the account.

## Facts

9. On or around January 31, 2011, Acadia's Chief Executive Officer contacted PHC's Chief Executive Officer to discuss Acadia's proposed acquisition of PHC. That same day, the PHC CEO updated the PHC board of directors on the discussions with Acadia and the proposed acquisition. Discussions continued throughout the next few months. Negotiations culminated in the execution of a final agreement on May 23, 2011. The agreement was announced publicly on the morning of May 24, 2011.

10. Eric Shear worked at PHC throughout this period, as Director of Business Development. Through his employment at PHC, Shear learned in or around the first half of April 2011 of activities regarding a significant transaction affecting PHC. Shear knew that the information about the PHC transaction was material and nonpublic, and that he had an obligation to maintain the confidentiality of the information and to refrain from trading on it. Shear violated his fiduciary duty to PHC and PHC's shareholders by trading while in possession of this information.

11. On April 14, 2011, after learning of the proposed transaction activities, Shear deposited $4,000 in Individual A's individual retirement account. On April 18, 2011, Shear used Individual A's login and password to access Individual A's individual retirement account. Shear used the funds he had deposited on April 14 to purchase 2,000 shares of PHC common stock.

12. On May 23, 2011, PHC and Acadia executed the merger agreement. At 8:45 a.m. on May 24, 2011, PHC and Acadia issued joint press releases announcing that the companies had entered into a definitive merger agreement.

13. The market reacted positively to the news. The closing last sale price of PHC on the day of the announcement was $3.61, an increase of approximately 20% over the prior day's close. Trading volume on the day of the announcement was 1.8 million shares, compared to PHC's historical average daily volume of approximately 56,700 shares.

14. As of the close of market on May 24, 2011, the PHC shares purchased by Shear on April 18, 2011 had increased in value by $2,968.

15. Shear purchased PHC shares on April 18, 2011 while in possession of material, nonpublic information about activities regarding a significant transaction involving PHC. Shear had learned this information through his employment at PHC, and knew that he had a fiduciary duty to maintain the information in confidence and to refrain from trading on it. Shear violated his fiduciary duty to PHC and PHC's shareholders by trading while in possession of this information.

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

## IV.

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

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondent Shear cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. Respondent shall, within 10 days of the entry of this Order, pay disgorgement of $2,968, which represents profits gained as a result of the conduct described herein; prejudgment interest of $416.28; and a civil money penalty in the amount of $2,968 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 or pursuant to 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 Eric Shear 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 Scott Friestad, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondent, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chair White
Not participating
Commissioner Piwowar
Disapproved

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

**SECURITIES ACT OF 1933**
**Release No. 9993 / December 18, 2015**

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| **In the Matter of**<br><br>**JPMorgan Chase Bank, N.A.**<br><br>**Respondent.** | **ORDER UNDER RULE 506(d) OF THE SECURITIES ACT OF 1933 GRANTING A WAIVER OF THE RULE 506(d)(1)(iii) DISQUALIFICATION PROVISION** |

## I.

JPMorgan Chase Bank, N.A. ("JPMCB") submitted a letter dated December 11, 2015 requesting that the Securities and Exchange Commission (the "Commission") grant a waiver of disqualification under Rule 506(d)(2)(ii) of Regulation D under the Securities Act of 1933 (the "Securities Act").

## II.

On December 18, 2015, the U.S. Commodity Futures Trading Commission (the "CFTC") entered order CFTC Docket No. 16-05 (the "CFTC Order") instituting proceedings pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, making findings and imposing remedial sanctions as a result of JPMCB's failure to adequately disclose certain conflicts of interest to clients.

## III.

Rule 506(d)(2)(ii) of Regulation D provides that disqualification "shall not apply. . . 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." The Commission has determined that as part of the Rule 506(d)(2)(ii) showing of good cause, JPMCB will comply with the following:

A. Retain, at JPMCB's expense and within sixty (60) days of the issuance of this Order, a qualified independent compliance consultant (the "Consultant") not unacceptable to Commission staff. JPMCB shall require the Consultant to conduct a comprehensive review of the policies and procedures relating to compliance with Rule 506 of Regulation D by JPMCB, including but not limited to policies and procedures relating to JPMCB's activities as an investment manager and placement agent to private funds relying on Rule

506 of Regulation D, and the subsidiaries of JPMCB conducting any activities that would otherwise be disqualified pursuant to the CFTC Order (together with JPMCB, the "Rule 506 Entities").

B. Cooperate fully with the Consultant, including providing the Consultant with access to the Rule 506 Entities' files, books, records, and personnel as reasonably requested for the review, obtaining the cooperation of employees or other persons under JPMCB's control, and permitting the Consultant to engage such assistance (whether clerical, legal, technological, or of any other expert nature) as necessary to achieve the purposes of the retention.

C. Require the Consultant to complete its review and submit a written report (the "Annual Report") to JPMCB, including its principal executive officer and principal legal officer, on an annual basis for a period of five years after the issuance of this Order. JPMCB shall require that the Consultant test the Rule 506 Entities' policies and procedures relating to Rule 506 of Regulation D by conducting a statistically valid random sampling of transactions conducted in reliance on Rule 506 of Regulation D.

D. The Consultant shall certify annually in the Annual Report that JPMCB's policies and procedures designed to ensure compliance by the Rule 506 Entities with their obligations under Rule 506 of Regulation D are reasonably designed to achieve their stated purpose.

E. Require JPMCB's principal executive officer and principal legal officer to certify in writing annually that they reviewed the Annual Report and to submit a copy of the certification and the Annual Report to Commission staff for public dissemination.

F. Require the Consultant to enter into an agreement that provides that for the period of engagement and for a period of two years from completion of the engagement, the Consultant shall not enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Rule 506 Entities, or any of their present or former affiliates, directors, officers, employees, or agents acting in their capacity as such. The agreement will also provide that the Consultant will require that any firm with which the Consultant is affiliated or of which the Consultant is a member, and any person engaged to assist the Consultant in performance of the Consultant's duties under this Order shall not, without prior written consent of Commission staff, enter into any employment, consultant, attorney-client, auditing or other professional relationship with the Rule 506 Entities, or any of their 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.

G. To ensure the independence of the Consultant, JPMCB shall not have the authority to terminate the Consultant without prior written approval of

Commission staff and shall compensate the Consultant and persons engaged to assist the Consultant for services rendered pursuant to this Order at their reasonable and customary rates.

H. With respect to any aspect of the Consultant's review or testing of (including recommendations relating to) policies and procedures that a Rule 506 Entity considers unduly burdensome, impractical or inappropriate, JPMCB shall propose in writing to the Consultant and the Commission staff an alternative approach designed to achieve the same objective or purpose. JPMCB and the Consultant shall attempt in good faith to reach an agreement within 30 days of such written proposal. Within 15 days after the conclusion of the discussion, JPMCB shall require that the Consultant inform JPMCB and the Commission staff in writing of the Consultant's final determination concerning any aspect of the Consultant's review, testing or recommendations that JPMCB considers to be unduly burdensome, impractical or inappropriate. JPMCB shall abide by the determination of the Consultant. For good cause shown, the Commission staff may extend any of the procedural dates relating to the conditions in this Order. 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.

**IV.**

Based on the foregoing and the facts and representations in JPMCB's request for a waiver of disqualification, and assuming that JPMCB complies with the CFTC Order and this Order, the Commission has determined that JPMCB has made a showing of good cause under Rule 506(d)(2)(ii) that it is not necessary under the circumstances to deny reliance on Rule 506 of Regulation D by reason of the entry of the CFTC Order. Any different facts from those represented or failure to comply with the terms of the CFTC Order or this Order would require us to revisit our determination that good cause has been shown and could constitute grounds to revoke or further condition the waiver. Further, for a period of five years from the date of this Order, if JPMCB is the subject of any action that triggers "ineligible issuer" status in Rule 405 of the Securities Act, disqualification under Section 9(a) of the Investment Company Act of 1940 or disqualification under Rule 506(d) of Regulation D, the Commission reserves the right, in its sole discretion, to revoke or further condition the waiver under those circumstances. In that event, JPMCB shall first be notified and have the opportunity to present to the Commission staff an analysis supporting why this waiver should not be revoked or further conditioned.

Accordingly, **IT IS ORDERED**, pursuant to Rule 506(d) of Regulation D under the Securities Act, that a waiver from the application of the disqualification provision of Rule 506(d)(1)(iii) under the Securities Act resulting from the entry of the CFTC Order is hereby granted to JPMCB.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

Chair White Not Participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 76699 / December 18, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-14958

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| In the Matter of<br><br>HURON CONSULTING GROUP INC., GARY L. BURGE, CPA, and WAYNE E. LIPSKI, CPA<br><br>Respondents. | ORDER AUTHORIZING THE TRANSFER TO THE U.S. TREASURY OF REMAINING FUNDS AND ANY FUNDS RETURNED TO THE FAIR FUND IN THE FUTURE, DISCHARGING THE FUND ADMINISTRATOR, AND TERMINATING THE FAIR FUND |

On July 19, 2012, the Securities and Exchange Commission ("Commission") issued an Order Instituting Cease-and-Desist Proceedings Pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order and Remedial Sanctions (the "Order") against Huron Consulting Group Inc. ("Huron"), Gary L. Burge, CPA ("Burge") and Wayne E. Lipski, CPA ("Lipski") (collectively, "Respondents") (Exchange Act Rel. No. 67472 (July 19, 2012)). In the Order, the Commission found, among other things, that the Respondents violated, or caused violations of, the reporting, books and records, and internal controls provisions of the Securities Exchange Act of 1934. The Order directed the Respondents to pay a total of $1,294,436.52 in disgorgement, prejudgment interest and penalties ("Huron Fair Fund" or "Fair Fund"). Huron and Lipski paid a total of $1,066,334.94 on or about July 25, 2012 and Burge paid a total of $228,101.58 on or about July 26, 2012. The amounts were placed in a non-interest-bearing account at the U.S. Department of the Treasury ("U.S. Treasury").

On December 13, 2012, the Commission issued a Notice of Proposed Plan of Distribution and Opportunity for Comment ("Notice") pursuant to Rule 1101 of the Commission's Rules on Fair Fund and Disgorgement Plans ("Commission's Rules"), 17 C.F.R. § 201.1101 (Exchange Act Rel. No. 68420 (December 13, 2012)). The Plan of Distribution ("Plan") proposed that the disgorgement, prejudgment interest, and the penalties paid by Respondents be transferred pursuant to Rule 1102(a) of the Commission's Rules, 17 C.F.R. § 201.1102(a), to the court registry account established for a related private class action[1] ("Class Action") for distribution to injured investors in accordance with a Plan of Allocation approved by the judge in the private Class Action. On January 25, 2013, the Commission issued an Order Establishing Fair Fund, Appointing a Fund Administrator, Approving Distribution Plan and Authorizing Transfer of Distribution Fund ("January 2013 Order") (Exchange Act Rel. No. 68737 (January 25, 2013)).

[1] *See Hughes v. Huron Consulting Group Inc., et al.*, No. 09-cv-4734 (N.D. Ill.).

Pursuant to the January 2013 Order, on or about March 8, 2013, the Huron Fair Fund totaling $1,294,436.52 was transferred to the Class Action. On or about April 12, 2013, a total of $23,294,936.01 was distributed *pro rata* to 4,011 injured investors who were harmed as a result of the Respondents' misconduct. Of this amount, $1,294,436.52 was attributable to the Huron Fair Fund. Of the $23,294,936.01 distributed, $72,376 was returned as undistributable. The balance of the Huron Fair Fund's portion of the undistributable amount is $4,024.16.

The Plan anticipated that all of the monies comprising the Huron Fair Fund would be distributed to injured investors with the Class Action settlement. Per the Plan, in the event any portion of the Fair Fund is not distributed, the remaining funds, less taxes, and any other fees/expenses that may be deducted are to be transferred to the Commission. The Plan further states that Commission staff will submit a final accounting to the Commission for approval. When the Commission has approved any such final accounting and the transfer of remaining funds, the Commission staff shall arrange for the transfer of any amount remaining in the Huron Fair Fund to the U.S. Treasury.

A final accounting, which was submitted to the Commission for approval as required by Rule 1105(f) of the Commission's Rules, 17 C.F.R. § 201.1105(f) and as set forth in the Plan, is now approved. Staff has verified with the Fund Administrator that all taxes, fees, and expenses have been paid, and the Commission is in possession of the remaining funds.

Accordingly, IT IS ORDERED that:

A. The remaining Fair Fund balance of $4,024.16, and any funds that may be returned to the Fair Fund in the future, shall be transferred to the U.S. Treasury;

B. The Fund Administrator, The Garden City Group, Inc., is discharged; and

C. The Fair Fund is terminated.

By the Commission.

Brent J. Fields
Secretary

Lynn M. Powalski

By: Lynn M. Powalski
Deputy Secretary

Chair White
Not participating

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933
Release No. 9992 / December 18, 2015

SECURITIES EXCHANGE ACT OF 1934
Release No. 76694 / December 18, 2015

INVESTMENT ADVISERS ACT OF 1940
Release No. 4295 / December 18, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-17008

In the Matter of

JPMorgan Chase Bank, N.A.
and J.P. Morgan Securities
LLC,

Respondents.

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 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

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## I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Section 15(b) 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 JPMorgan Chase Bank, N.A. ("JPMCB") and J.P. Morgan Securities LLC ("JPMS" and, together with JPMCB, "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. Respondents admit the facts set forth in Section III.B below, acknowledge that the conduct set forth in Section III.B violated the federal securities laws, admit the Commission's jurisdiction over them and the subject matter of these proceedings, and consent to the entry of this 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 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 Respondents' Offers, the Commission finds that:

### A. Summary

1. This matter concerns the negligent failure of JPMorgan Chase & Co.'s ("JPMorgan's") wealth management businesses, JPMorgan Chase Bank, N.A. ("JPMCB") and J.P. Morgan Securities LLC ("JPMS"), to disclose conflicts of interest arising from, as applicable, preferences for (i) JPMorgan-managed mutual funds ("Proprietary Mutual Funds"), (ii) JPMorgan-managed private hedge funds ("Proprietary Hedge Funds," and, together with Proprietary Mutual Funds, "Proprietary Funds"), and (iii) third-party-managed private hedge funds that shared client fees with a JPMCB affiliate.

2. From May 2008 to 2013, JPMS failed to disclose that it designed and operated Chase Strategic Portfolio ("CSP"), a retail unified managed account program, with a preference for Proprietary Mutual Funds. JPMS also failed to disclose that there was an economic incentive to invest CSP Assets in Proprietary Mutual Funds as a result of discounted pricing for services provided to JPMS for CSP by a JPMS affiliate. The discounts were based on the amount of CSP assets that JPMS invested in Proprietary Mutual Funds. Finally, until November 2013, JPMS failed to disclose to CSP clients the availability of certain less expensive Proprietary Mutual Fund share classes. As a result, Respondent JPMS breached its fiduciary duty to CSP clients by failing to adequately disclose conflicts of interest.

3. JPMCB likewise failed to disclose a preference for Proprietary Funds to discretionary managed account clients of two U.S.-based wealth management businesses: J.P. Morgan Private Bank ("JPM U.S. Private Bank") and Chase Private Client ("CPC"). From 2011 to 2014, JPMCB failed to disclose its preference for Proprietary Mutual Funds to JPM U.S. Private Bank clients with discretionary managed accounts and to CPC clients invested in a discretionary managed account program called J.P. Morgan Investment Portfolio. In addition, JPMCB failed to disclose to JPM U.S. Private Bank clients with discretionary managed accounts, from 2008 until 2014, its preference for Proprietary Hedge Funds and, from 2008 until August 2015, its preference for third-party-managed hedge funds that shared their management and/or performance fees with a JPMCB affiliate. As a result, Respondent JPMCB did not satisfy its disclosure duty to certain of its affluent, high net worth and ultra-high net worth clients who invested through discretionary accounts.

## Respondents

4. **JPMorgan Chase Bank, N.A. ("JPMCB")**, a wholly-owned subsidiary of JPMorgan, is a nationally-chartered bank, incorporated in 1824, and headquartered in New York, New York. JPMCB acts as the investment manager for certain discretionary portfolios offered primarily to clients of the JPM U.S. Private Bank, the marketing name for JPMorgan's U.S. business unit that provides banking and investment services to high net worth and ultra-high net worth clients. JPMCB is not registered under the Advisers Act, as it is excluded from the definition of investment adviser pursuant to Section 202(a)(11)(A) of the Advisers Act.

5. **J. P. Morgan Securities LLC ("JPMS")**, a wholly-owned subsidiary of JPMorgan, is a Delaware company headquartered in New York, New York. JPMS has been registered with the Commission as an investment adviser since 1965 and as a broker-dealer since 1985. JPMS or its affiliates[1] have offered CSP through more than 2,800 financial advisors located in Chase bank branches nationwide from CSP's launch in 2008 to the present.

## Other Relevant Entities and Lines of Business

6. **JPMorgan Chase & Co. ("JPMorgan")** is a Delaware corporation headquartered in New York, New York. JPMorgan is a global financial services firm and bank with \$2.6 trillion in assets as of December 31, 2014.

7. **JPMorgan Asset Management ("JPMAM")** is one of JPMorgan's primary business units and oversees, among other businesses, JPM U.S. Private Bank and JPMorgan's Proprietary Funds business. As of December 31, 2014, JPMAM had \$1.7 trillion in assets under management.

[1] From CSP's inception in 2008 through September 2012, Chase Investment Services Corp. ("CISC"), an affiliate of JPMS that was registered as an investment adviser and broker-dealer from 1990 to 2012, offered and managed CSP. On October 1, 2012, CISC was merged into JPMS, and JPMS became the investment adviser for CSP.

8. **J.P. Morgan's U.S. Private Bank ("JPM U.S. Private Bank")** is the marketing name of a business unit within JPMAM that operates in the U.S. and provides banking and investment management services to high net worth and ultra-high net worth individuals through JPMCB. As of December 31, 2014, JPM U.S. Private Bank had approximately $207 billion in assets under management. (This excludes JPMorgan-managed funds purchased in self-directed brokerage accounts.) Hereinafter, reference to JPMCB will encompass both JPMCB and JPM U.S. Private Bank.

## B. Facts

9. As set out more fully below, during the relevant period, JPMS and JPMCB failed to adequately disclose certain conflicts of interest to their clients.

### Chase Strategic Portfolio

10. In early 2007, JPMS and JPMAM (which, among other things, oversees JPMorgan's Proprietary Funds business), began developing CSP, a unified managed account program, for distribution to retail investors through JPMS-affiliated advisors located in Chase bank branches across the country. CSP's minimum account value has always been $50,000 and its current median account value is approximately $110,000.

11. As a unified managed account program, CSP comprised a set of standardized, risk-weighted portfolios of predominantly registered funds. JPMS (or, beginning in September 2013, an affiliate of JPMS engaged to serve as sub-adviser) selected the constituent holdings for each CSP portfolio and set the percentage of assets invested in each holding in the various CSP portfolios. For example, the entry-level "Conservative" portfolio in late 2009 held 12 mutual funds, seven of which were Proprietary Mutual Funds. JPMS allocated 57% of this portfolio's assets to Proprietary Mutual Funds.

*JPMS Failed to Disclose that It Preferred to Invest CSP Assets in Proprietary Mutual Funds*

12. JPMS and JPMAM designed CSP with an expectation that a majority of CSP's assets would be in Proprietary Mutual Funds, as well as JPMAM-managed money market funds and separately managed accounts (together with Proprietary Mutual Funds, "Proprietary CSP Assets"). JPMAM correspondingly would benefit from the management fees earned from these allocations.

13. From approximately June 2007 to March 2008, the fund research team servicing CSP conducted quantitative and qualitative due diligence. The team first applied a quantitative scoring methodology that awarded points to potential funds based on a series of analytical metrics. It next conducted a qualitative review which, among other things, included fund manager interviews and incorporated judgments about those managers' investment philosophies. As part of its review, the fund research team exercised a preference for Proprietary Mutual Funds.

14. JPMS launched CSP in May 2008 and, consistent with an expectation that a majority of CSP's assets would be in Proprietary CSP Assets, JPMS invested approximately 60% of CSP client assets in Proprietary CSP Assets. Since that time, JPMS has continuously operated CSP with a preference for Proprietary Mutual Funds.

15. From 2008 to 2013, CSP grew rapidly and by December 2013, JPMS had invested approximately $10 billion in Proprietary Mutual Funds out of a total of $32.6 billion of CSP client mutual fund assets. From early 2009 until early 2012, JPMS invested approximately 47% to 51% of CSP client mutual fund assets in Proprietary Mutual Funds. Thereafter, the percentage began to decrease, falling to 45% by mid-2012, to approximately 31% by year-end 2013 and 27% by year-end 2014.

16. From 2008 through August 5, 2013, neither CSP's Schedule H or its successor Form ADV Part 2A (collectively, "CSP ADV") nor CSP marketing materials disclosed that JPMS preferred Proprietary Mutual Funds. JPMS also failed to disclose that JPMS and JPMAM had designed CSP to feature Proprietary Mutual Funds, that JPMS had an expectation that it would invest a majority of CSP client assets in Proprietary CSP Assets at the beginning of the program, and that JPMAM had this expectation from the beginning of the program until early 2013.

*JPMS Failed to Disclose That JPMAM Provided Discounted Services to CSP Based on the Amount of CSP Assets JPMS Invested in Proprietary CSP Assets*

17. JPMS contracted with an affiliate in JPMAM to provide various services to CSP, including "overlay services" (i.e., trading and reporting services related to the management of CSP portfolios) and, later, asset allocation, portfolio construction, and tactical trading advice.

18. JPMAM tied both its willingness to provide services to JPMS and the pricing for those services to the amount of CSP's assets that JPMS invested in Proprietary CSP Assets. Between 2008 and 2013, JPMS failed to disclose that the discounted pricing of services provided to JPMS by a JPMAM affiliate was tied to the amount of CSP assets that JPMS invested in Proprietary CSP Assets. JPMS also did not disclose for a period of time that JPMAM's provision of services to CSP was tied to JPMS's investment of the majority of CSP assets in Proprietary CSP Assets.

*JPMS Failed to Disclose the Availability of Lower Cost Share Classes*

19. When selecting mutual funds for CSP, JPMS typically negotiated with the funds' advisers regarding, among other things, the share class into which it would invest CSP clients. Different share classes have different minimum investment amounts and fee structures, but otherwise reflect an identical interest in the funds. For example, institutional share classes usually require a minimum $1 million investment and have lower distribution and shareholder servicing fees than share classes available to retail investors. The difference in fees between institutional and retail share classes is typically 65 basis points or more.

20. JPMS's CSP ADV described the share classes available in the program as follows: "Fund shares sold in [CSP] are generally investor or institutional class shares, or no load or load-waived Class A shares that are sold at net asset value." CSP clients were informed in writing prior to account opening of the share class they would be receiving and the fees associated with that share class.

21. Certain of the Proprietary Mutual Funds used in CSP offered, in addition to retail share classes, two different institutional share classes: (a) a "Select" share class (with an investment minimum of $1 million) and (b) an "Institutional" share class (with an investment minimum of $3 million). For a majority of the Proprietary Mutual Funds used in CSP, the "Select" share class was the only institutional share class offered by the fund.

22. From 2008 to 2013, a minority of the Proprietary Mutual Funds used in CSP offered both Select and Institutional classes. In certain of these funds, JPMS invested CSP client assets in the Select share class even though the lower cost Institutional class was available. The Select share class typically had a shareholder servicing fee that was 15 basis points higher than the Institutional share class offered by those Proprietary Mutual Funds. As a result, JPMAM earned higher fees when JPMS invested CSP client assets in the Select share class. In November 2013, JPMS converted all CSP client investments in Select shares to Institutional shares where the Proprietary Mutual Funds offered Institutional shares.

23. Between 2008 and 2013, JPMS failed to disclose that certain of the Proprietary Mutual Funds purchased for CSP clients offered Institutional shares that were less expensive, and would generate less revenue for a JPMS affiliate, than the Select shares JPMS chose for CSP clients.

*JPMS's Forms ADV Failed to Adequately Disclose Conflicts of Interest*

24. From May 2008 to February 2013, JPMS filed nine CSP ADVs with the Commission.

25. JPMS's CSP ADVs described the quantitative and qualitative criteria used during the fund selection process. For example, the CSP ADV dated March 2011 stated: "Both affiliated and non-affiliated [Mutual] Funds...are evaluated and monitored using the same criteria."

26. In its CSP ADV filings, JPMS disclosed certain conflicts of interest. For example, JPMS disclosed that an affiliate performed overlay services for CSP. Additionally, JPMS disclosed the conflict of interest arising from the use of Proprietary Mutual Funds. For example, the versions of the CSP Schedule H in effect in 2009 and 2010 provided that JPMS "may have a conflict of interest in including affiliated [Mutual] Funds...because [JPMS] and/or its affiliates will receive additional compensation."

27. In addition, in advance of account opening, CSP clients were informed which funds were proposed for their CSP portfolio, and how much of the portfolio's assets were to be allocated to each Proprietary Mutual Fund and each third-party mutual fund. Once the account

was open, CSP clients were informed of which funds were in their account and the amount of assets allocated to those funds through, for example, periodic account statements and client reviews. Marketing materials used with potential CSP clients also disclosed which funds were to comprise a portfolio and the amount of portfolio assets allocated to each fund.

28. However, in its CSP ADV filings, JPMS did not disclose that it had exercised a preference for Proprietary Mutual Funds in CSP. JPMS also failed to disclose that the discounted pricing of services provided to JPMS for CSP by a JPMAM affiliate was tied to the amount of CSP assets that JPMS invested in Proprietary CSP Assets. Finally, JPMS's CSP ADV filings did not disclose that, for certain of the Proprietary Mutual Funds in which it invested CSP clients, less expensive share classes were available.

29. On August 5, 2013, JPMS filed an amended CSP ADV that disclosed there "may" be a preference for Proprietary Mutual Funds in CSP. On December 31, 2013, JPMS further amended the CSP ADV to disclose that "[a]s a general matter, we prefer" Proprietary Mutual Funds.

### *JPMS Failed to Implement Written Policies and Procedures Reasonably Designed to Prevent Violations of the Advisers Act and the Rules Thereunder*

30. JPMS did not implement its written policies and procedures to ensure adequate disclosure of the conflicts of interest discussed above. From 2008 to 2012, JPMS's written policies and procedures required that JPMS avoid any actual or potential conflict of interest and that any such conflict be disclosed to clients with discretionary managed accounts. On certain occasions, the disclosure concerning the use of Proprietary Mutual Funds in CSP was raised, and discussed among JPMS personnel, but was not adequately addressed. Policies and procedures were insufficiently implemented to ensure that (a) the disclosures relating to the above conflicts of interest were sufficiently reviewed and (b) the above conflicts of interest were adequately disclosed to CSP clients. As a result, JPMS did not implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.

## **JPMorgan Chase Bank, N.A.**

31. JPMCB provides wealth management services to clients with three progressively higher levels of wealth: affluent, high net worth, and ultra-high net worth. Through JPM U.S. Private Bank, JPMCB serves high net worth and ultra-high net worth clients. JPMCB serves as the fiduciary investment manager for discretionary, diversified, risk-adjusted investment management accounts ("IM accounts") that can hold, among other investments, mutual funds and hedge funds.

32. JPMCB also serves as investment manager to certain private funds, known as the Global Access Portfolios ("GAP"), that offer to JPM U.S. Private Bank clients diversified portfolios comprised of, among other underlying investments, mutual funds and/or hedge funds. The GAP private funds may be held in an IM account ("GAP IM Holdings").

33. In 2007, JPMCB and JPMS jointly developed J.P. Morgan Investment Portfolio ("JPMIP"), a new managed account product to be marketed as part of a new banking and wealth management business called Chase Private Client. JPMIP was offered to affluent Chase banking clients. JPMIP accounts were identical to certain IM accounts, with investments in mutual funds, for example.

*JPMCB Failed to Disclose its Preference for Proprietary Funds*

34. JPMCB prefers Proprietary Funds in IM accounts, GAP private funds, and JPMIP and expects that a significant percentage of relevant portfolio assets will be invested in Proprietary Funds. For example, in early 2011, JPMCB had invested 47% of mutual fund assets and 35% of hedge fund assets in JPMCB IM client accounts in Proprietary Funds.

35. From December 2006 to February 2011, JPMCB disclosed its preference for Proprietary Mutual Funds in what was entitled "JPMorgan general investment principles regarding the use of JPMorgan Funds and external managers" (the "Investment Principles"). The Investment Principles were distributed to relevant clients through various means including the incorporation of the Investment Principles into the JPMorgan Fund Disclosure Statement ("FDS"), a document provided to new IM account clients (including those with GAP IM Holdings), JPMIP clients, and to clients with existing accounts in an annual mailing. In January 2011, JPMCB mistakenly removed the Investment Principles (including language stating "we prefer to use JPMorgan-affiliated managers") from the FDS while amending the FDS for reasons unrelated to the language on a preference. By January 2011, the FDS was the sole means by which the Investment Principles were being affirmatively distributed to clients on a systematic basis. Therefore, from February 2011 until January 2014, JPMCB did not disclose a preference for Proprietary Mutual Funds in account documentation.

36. JPMCB disclosed that it had a conflict of interest when it invested its clients' discretionary portfolio assets in Proprietary Funds, as such investments increased revenue to affiliates. In addition, clients were informed of which funds were in their discretionary portfolios, as well as the amount of assets held in each Proprietary Fund and third-party fund through, for example, periodic account statements and client reviews. However, during the time period of February 2011 to January 2014, no account opening documents or marketing materials disclosed to IM account clients (including those with GAP IM Holdings) or JPMIP clients that JPMCB preferred to invest client assets in Proprietary Mutual Funds.

37. With respect to those portfolios that might be invested in private hedge funds, account opening documents disclosed JPMCB's conflict of interest when investing client assets in Proprietary Hedge Funds. However, from 2008 through January 2014, JPMCB did not disclose its preference for investing IM account or GAP IM Holding assets in Proprietary Hedge Funds.

38. Beginning in January 2014, language providing that "[a]s a general matter, we prefer" Proprietary Funds was incorporated into account opening documentation, the FDS, account statements, marketing materials and other documentation used with IM account clients (including those with GAP IM Holdings) and JPMIP clients.

*JPMCB Failed to Disclose its Preference for Retrocession-Paying Third-Party Hedge Fund Managers*

39. For the IM accounts, GAP private funds, and JPMIP accounts, JPMCB uses the investment funds on what is known as the "Private Bank Platform." With respect to most of the private hedge funds on the Private Bank Platform, a broker-dealer affiliate of JPMCB acts as the placement agent and earns fees for placement, shareholder servicing and other ongoing services. These placement agent fees are typically referred to as "retrocessions" and are usually a portion of the private hedge fund managers' management and/or performance fees earned on relevant client assets. The standard retrocession that the broker-dealer affiliate of JPMCB receives from a third-party hedge fund is approximately 1.0% of the market value of relevant client assets invested, paid on an annual basis. Retrocessions are not additional fees paid by JPM U.S. Private Bank clients; rather, the retrocessions are paid by the hedge funds and/or their sponsors.

40. Beginning in at least 2005, JPMCB sought retrocessions from third-party private hedge fund managers under consideration for inclusion on the Private Bank Platform. During introductory meetings, the third-party hedge fund managers were typically asked about their willingness to pay retrocessions. If a manager declined to pay retrocessions, an alternative manager with a similar investment strategy that would pay retrocessions was typically sought. Currently all but one of the third-party-managed hedge funds on the Private Bank Platform and available for direct investment in IM accounts pay retrocessions to JPMCB affiliates.

41. JPMCB disclosed to its IM account clients (including those with GAP IM Holdings) that its affiliates may receive retrocessions in connection with investments in third-party hedge funds and informed some clients that retrocessions lowered client fees by reducing the clients' total costs to access the hedge funds on the Private Bank Platform. However, JPMCB did not disclose its preference for retrocession-paying third-party hedge fund managers in IM accounts and GAP IM Holdings until August 2015, when it added additional language to certain client documentation regarding the extent to which such funds are used in certain discretionary portfolios.

## C. Remedial Actions

42. In determining to accept Respondents' Offers, the Commission considered remedial acts promptly undertaken by Respondents and cooperation afforded the Commission staff. Respondents retained an independent compliance consultant ("ICC") to review policies and procedures concerning disclosures of conflicts of interest; the ICC has completed its review and issued recommendations; and Respondents have accepted and implemented the ICC's recommendations.

43. Respondents have agreed to provide notice of these proceedings to their JPMS and JPM U.S. Private Bank clients and prospective clients with CSP, JPMIP, and IM accounts (including IM accounts with GAP IM Holdings) ("relevant client(s)") as follows:

a. Within ninety (90) days of the date of entry of this Order, Respondents shall (1) post on their website a brief description of these proceedings in a form and location not unacceptable to Commission staff, and accessible to relevant clients, with a hyperlink to this Order and (2) provide a brief description of these proceedings with a link or hyperlink to this Order to each relevant client by mail or email, in a form not unacceptable to the Commission staff; or by such other method as may be acceptable to the Commission staff. Hyperlinks or links to the Order provided to relevant clients and on Respondents' websites shall remain active for a period of one year from the date of entry of this Order;

b. Respondent JPMS further agrees, for a period of one year from the date of entry of this Order, to the extent that it is required to deliver a brochure to a CSP client and/or prospective CSP client pursuant to Rule 204-3 of the Advisers Act, to provide a brief description of these proceedings by mail or email, with a link or hyperlink to this Order, to such CSP client at the same time that JPMS delivers the brochure.

## D. <u>Violations</u>

44. As a result of the conduct described above, JPMS willfully[2] violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from, directly or indirectly, engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client.

45. As a result of the conduct described above, JPMS willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and its rules.

46. As a result of the conduct described above, JPMS willfully violated Section 207 of the Advisers Act, which makes it "unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission . . . or willfully to omit to state in any such application or report any material fact which is required to be stated therein."

47. As a result of the conduct described above, JPMCB willfully violated Sections 17(a)(2) and 17(a)(3) of the Securities Act, which, respectively, prohibit making untrue statements of material fact or material omissions in the offer or sale of securities and engaging in a course of business which operates as a fraud or deceit in the offer or sale of securities.

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[2] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)). The actor may be found to have acted willfully even if, as here, the violations resulted from negligent conduct.

# IV.

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 Section 8A of the Securities Act, Section 15(b) of the Exchange Act, and Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent JPMorgan Chase Bank, N.A. cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

B. Respondent J.P. Morgan Securities LLC 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.

C. Respondent J.P. Morgan Securities LLC is censured.

D. Respondents, jointly and severally, shall, within 14 days of the entry of this Order, pay disgorgement, which represents profits gained as a result of the conduct described herein of $127,500,000 and prejudgment interest of $11,815,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). Respondents, jointly and severally, shall, within 14 days of the entry of this Order, pay a civil money penalty in the amount of $127,500,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). 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) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondents 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) Respondents 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 JPMorgan Chase Bank, N.A. and J.P. Morgan Securities LLC as Respondents 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 Valerie A. Szczepanik, Assistant Director, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, New York Regional Office, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, NY 10281-1022, and to Timothy Casey, Assistant Director, Legal Operations, New York Regional Office, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, NY 10281-1022, or such other person or address as the Commission staff may provide.

By the Commission.

Brent J. Fields
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. 76704 / December 21, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-12068**

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| **In the Matter of**<br><br>**INTERNATIONAL EQUITY ADVISORS, LLC AND RICHARD ROGER LUND,**<br><br>**Respondents.** | **ORDER AUTHORIZING THE TRANSFER TO THE U.S. TREASURY OF RESIDUAL FUNDS AND ANY FUNDS RECEIVED BY THE FAIR FUND IN THE FUTURE, DISCHARGING THE FUND ADMINISTRATOR, AND TERMINATING THE FAIR FUND** |

On September 30, 2005, the Commission issued an Order Instituting Administrative and Cease-and-Desist Proceedings, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Section 203(f) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company Act of 1940 ("Order") against International Equity Advisors, LLC and Richard Roger Lund (collectively, "Respondents") (Securities Act Release No. 8621 (September 30, 2005)). The Order required Respondents to jointly and severally pay $2,500,000 in disgorgement, plus $190,000 in prejudgment interest and a civil money penalty of $500,000. By separate order issued on December 23, 2005, the Commission established a Fair Fund pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002.[1] A total of $3,190,000 was paid into the Fair Fund by Respondents, with the funds deposited into an interest-bearing account at the U.S. Department of the Treasury ("U.S. Treasury").

On August 8, 2007, the Commission issued an Order Approving Distribution Plan. The same order also appointed Stephen E. Donahue as the Fund Administrator (Exchange Act Release No. 56220 (August 8, 2007)). On September 8, 2008, the Commission issued an Order Directing Disbursement of Fair Fund that authorized a disbursement of $3,419,686.62 to mutual funds that had been determined to be "Eligible Mutual Funds" pursuant to the Plan of Distribution (Exchange Act Release No. 58490 (September 8, 2008)).

On or about September 22, 2008, the Fair Fund made 71 disbursements totaling $3,419,686.62 to Eligible Mutual Funds that were affected by the conduct discussed in the Order. After the initial disbursements, a total of $86,860.04 was returned from six funds because contact

[1] Order Establishing Fair Fund, Securities Act Rel. No. 8648 (December 23, 2005).

information had changed due to successor funds, new bank account information was required and/or funds had been liquidated. The staff worked to track down updated information and subsequent rounds of disbursements were made. In the end, another $74,891.14 was disbursed. The staff was not able to disburse $11,968.90 which remained in the Fair Fund, from which all but the remaining $3,033.87 was ultimately used to pay Fair Fund expenses.[2] The Fair Fund paid a total of $130,539.70 in taxes and $25,701.90 in Tax Administrator fees and expenses, plus another $111.08 in bank fees.

The Plan of Distribution provides that the Fair Fund shall be eligible for termination after all of the following have occurred: (1) the final accounting has been submitted by the Fund Administrator for approval of, and has been approved by, the Commission; (2) all taxes, fees and expenses have been paid; and (3) any amount remaining in the Fair Fund has been transferred to the U.S. Treasury. A final accounting report was submitted to the Commission pursuant to Rule 1105(f) of the Commission's Rules on Fair Fund and Disgorgement Plans and has been approved. In addition, all taxes, fees and expenses have been paid and the Commission is in possession of the remaining funds.

Accordingly, IT IS ORDERED that:

1. The $3,033.87 balance in the Fair Fund shall be transferred to the U.S. Treasury, and any funds received by the Fair Fund in the future 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.

Brent J. Fields
Secretary

Lynn M. Powalski
By: Lynn M. Powalski
Deputy Secretary

[2] The staff made multiple attempts to obtain disbursement information for the $11,968.90 due to HSBC International Equity Fund, which had been liquidated. The staff provided counsel for HSBC with a firm deadline to respond and received no follow up.

**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76722 / December 21, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-15641**

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| In the Matter of<br><br>GLG PARTNERS, INC. and<br>GLG PARTNERS, L.P.<br><br>Respondents. | ORDER DIRECTING DISBURSEMENT OF FAIR FUND |

On September 19, 2014, the Commission issued a Notice of Proposed Plan of Distribution and Opportunity for Comment[1] ("Notice") pursuant to Rule 1103 of the Commission's Rules on Fair Fund and Disgorgement Plans.[2] The Notice advised interested parties that they could obtain a copy of the proposed Plan of Distribution ("Plan") from the Commission's public website or by submitting a written request to Nancy Chase Burton, Esq., United States Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5631. The Notice also advised that all persons desiring to comment on the Plan could submit their comments, in writing, no later than thirty (30) days from the publication of the Notice. The Commission received no comments on the Plan. On October 24, 2014, the Commission issued an Order Approving Plan of Distribution.[3] The Plan provides for the distribution of the disgorgement, prejudgment interest and civil penalties paid by Respondents, plus any accumulated interest that could have been earned, less any reserve for taxes, fees, or other expenses of administering the Plan (the "Fair Fund") to eligible clients according to the methodology set forth in the Plan.

The Fund Administrator has submitted to Commission staff a payment file with a list of payees and their respective payment amounts. Commission staff has reviewed the payment file and requests that, pursuant to Rule 1101(b)(6) of the Commission's Rules on Fair Fund and Disgorgement Plans,[4] the Commission direct the payment of $8,406,000 from the Fair Fund to

[1] Exchange Act Release No. 73155 (Sep. 19, 2014).
[2] 17 C.F.R. § 201.1103.
[3] Exchange Act Release No. 73423 (Oct. 24, 2014).
[4] 17 CFR § 201.1101(b)(6).

The Huntington National Bank for distribution by the Fund Administrator as provided for in the Plan.

Accordingly, it is ORDERED that the Commission staff shall direct the payment of $8,406,000 from the Fair Fund to The Huntington National Bank, and that the Fund Administrator shall distribute such monies to eligible clients as provided for in the Plan.

By the Commission,

Brent J. Fields
Secretary

By: Lynn M. Powalski
Deputy Secretary

**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES ACT OF 1933**
**Release No. 9994 / December 21, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17010**

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| **In the Matter of**<br><br>**the Registration Statement of**<br><br>**Scription Work Solutions, Inc.**<br>**(f/k/a Transtech Solutions, Inc.)**<br>**848 N. Rainbow Blvd., Unit 1175**<br>**Las Vegas, NV 89107**<br><br>**Respondent.** | **ORDER FIXING TIME AND PLACE OF PUBLIC HEARING AND INSTITUTING PROCEEDINGS PURSUANT TO SECTION 8(d) OF THE SECURITIES ACT OF 1933** |

## I.

The Commission's public official files disclose that:

On March 29, 2013, Respondent filed a Form S-1 registration statement seeking to register the offer and sale of 20 million common shares. The registration statement was amended on May 10, 2013, June 5, 2013, June 28, 2013, October 7, 2013, October 7, 2013, November 1, 2013, November 25, 2013, and January 21, 2014 (together, the "Registration Statement"). The Registration Statement has not been declared effective.

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Respondent is a revoked Nevada corporation headquartered in Las Vegas, Nevada. Respondent is delinquent with its annual filing fee obligations and its submission of its list of officers. It has not paid filing fees nor submitted its list of officers from July 31, 2015 to present.

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B. MATERIAL MISSTATEMENTS AND OMISSIONS

2. The Registration Statement includes untrue statements of material facts and omits to state material facts necessary to make the statements contained therein not misleading. The untrue statements and omissions of material facts are as follows:

a. The Registration Statement states that Respondent has a sole officer and director and that "[w]e currently rely on [our sole officer and director] to manage all aspects of our business." These disclosures are false and misleading because Respondent has undisclosed control persons and/or promoters, who are different than the sole officer and director listed in the Registration Statement. One of the undisclosed control persons and/or promoters:

i. drafted Respondent's Form S-1, and communicated with the law firm that facilitated Respondent's the filing of Respondent's Registration Statement providing it with draft responses to staff's comments to Respondent's Registration Statement;
ii. interacted with Respondent's auditors regarding its financial statements;
iii. provided false consulting invoices to Respondent's auditors; and
iv. has custody and control of Respondent's corporate records.

b. The Registration Statement states that Respondent is engaged in "Phase 1" of a two-phase business plan that included expenditures related to incorporation and drafting a business plan. The remaining portion of Phase 1 was to acquire additional funding. This disclosure is false and misleading because Respondent's sole officer and director improperly withdrew $25,000 from Respondent's bank account to fund one of his other medical transcription businesses.

c. The Registration Statement states that since 2001 Respondent's sole officer and director "has been a Senior Partner at 'mypharmacard'" and that "his experience working in the medical industry with 'mypharmacare' will assist Scription Work Solutions, Inc. and grow the business." These disclosures are false and misleading because neither "mypharmacard" nor "mypharmacare" exist.

## III.

The Commission, having considered the aforesaid, deems it appropriate and in the public interest that public proceedings pursuant to Section 8(d) of the Securities Act be instituted with respect to the Registration Statement to determine whether the allegations of the Division of Enforcement are true; to afford the Respondent with an opportunity to establish any defenses to these allegations; and to determine whether a stop order should issue suspending the effectiveness of the Registration Statement referred to herein.

Accordingly, IT IS ORDERED that public proceedings be and hereby are instituted under Section 8(d) of the Securities Act, such hearing to be commenced at 9:30 a.m. on January 7, 2016, at the Commission's offices at 100 F Street N.E., Washington, DC 20549, and to continue thereafter at such time and place as the hearing officer may determine.

IT IS FURTHER ORDERED that these proceedings shall be presided over by an Administrative Law Judge to be designated by further order, who is authorized to perform all the duties of an Administrative Law Judge as set forth in the Commission's Rules of Practice or as otherwise provided by law.

IT IS FURTHER ORDERED that the Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, pursuant to Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220. If the Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against the Respondent upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§201.155(a), 201.220(f), 201.221(f) and 201.310. This Order shall be served forthwith upon the Respondent in accordance with Rule 141 of the Commission's Rules of Practice, 17 C.F.R. §201.141.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice. In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision 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.

Brent J. Fields
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. 9995 / December 21, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17011**

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| **In the Matter of**<br><br>**the Registration Statement of**<br><br>**Blue Mountain Eco Tours, Inc.**<br>**11 Rocky Road, Queensborough**<br>**Kingston, Jamaica 19**<br><br>**Respondent.** | **ORDER FIXING TIME AND PLACE OF PUBLIC HEARING AND INSTITUTING PROCEEDINGS PURSUANT TO SECTION 8(d) OF THE SECURITIES ACT OF 1933** |

## I.

The Commission's public official files disclose that:

On April 25, 2012, Respondent filed a Form S-1 registration statement seeking to register the offer and sale of 3,041,000 common shares. The registration statement was amended on August 13, 2012, January 24, 2013, August 2, 2013, September 20, 2013, October 10, 2013, October 29, 2013, and November 12, 2013 (together, the "Registration Statement"). The Registration Statement has not been declared effective.

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Respondent is a revoked Nevada corporation headquartered in Kingston, Jamaica. Respondent is delinquent with its annual filing fee obligations and its submission of its list of officers. It has not paid filing fees nor submitted its list of officers from December 31, 2012 to present.

B. <u>MATERIAL MISSTATEMENTS AND OMISSIONS</u>

2. The Registration Statement includes untrue statements of material facts and omits to state material facts necessary to make the statements contained therein not misleading. The untrue statements and omissions of material facts are as follows:

a. The Registration Statement states that Respondent has a sole officer and director and that "[w]e have no significant employees other than our sole officer and director…" These disclosures are false and misleading because Respondent has undisclosed control persons and/or promoters, who are different than the sole officer and director listed in the Registration Statement. One of the undisclosed control persons and/or promoters:

i. had sole signatory authority over Respondent's bank account;
ii. was listed as Respondent's corporate secretary;
iii. authorized over 30 ATM withdrawals from Respondent's bank account for unknown purposes;
iv. paid fees to professionals that facilitated the filing of Respondent's Registration Statement, including to its auditor and attorney;
v. withdrew thousands of dollars of so-called consulting fees and travel expenses from Respondent's bank account;
vi. established Respondent's website;
vii. communicated with the law firm that facilitated the filing of Respondent's Registration Statement providing it with drafts of its Form S-1 and draft responses to the Commission's Division of Corporation Finance staff's comments to Respondent's Registration Statement; and
viii. has custody of all of Respondent's corporate documents.

b. The Registration Statement states that the Respondent's sole officer and director loaned $15,219 to the company. This disclosure is false and misleading because Respondent's sole officer and director did not loan any money to Respondent.

c. The Registration Statement states that Respondent repaid its sole officer and director $10,000 of the loan. This disclosure is false and misleading because Respondent did not repay any money to its sole officer and director.

d. The Registration Statement states that Respondent's sole officer and director "earned the Sustainable Travel Certification." This disclosure is false and misleading because Respondent's sole officer and director did not earn the Sustainable Travel Certification.

e. The Registration Statement states that Respondent was founded in Montego Bay, Jamaica with the company "providing hiking expeditions into the Blue Mountain region." This disclosure is false and misleading because Respondent was not founded in Montego Bay, Jamaica and has no operations.

f. The Registration Statement states that Respondent is a Nevada corporation. This disclosure is false and misleading because Respondent's corporate status is listed as "revoked."

## III.

The Commission, having considered the aforesaid, deems it appropriate and in the public interest that public proceedings pursuant to Section 8(d) of the Securities Act be instituted with respect to the Registration Statement to determine whether the allegations of the Division of Enforcement are true; to afford the Respondent with an opportunity to establish any defenses to these allegations; and to determine whether a stop order should issue suspending the effectiveness of the Registration Statement referred to herein.

Accordingly, IT IS ORDERED that public proceedings be and hereby are instituted under Section 8(d) of the Securities Act, such hearing to be commenced at 9:30 a.m. on January 8, 2016, at the Commission's offices at 100 F Street N.E., Washington, DC 20549, and to continue thereafter at such time and place as the hearing officer may determine.

IT IS FURTHER ORDERED that these proceedings shall be presided over by an Administrative Law Judge to be designated by further order, who is authorized to perform all the duties of an Administrative Law Judge as set forth in the Commission's Rules of Practice or as otherwise provided by law.

IT IS FURTHER ORDERED that the Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, pursuant to Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220. If the Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against the Respondent upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§201.155(a), 201.220(f), 201.221(f) and 201.310. This Order shall be served forthwith upon the Respondent in accordance with Rule 141 of the Commission's Rules of Practice, 17 C.F.R. §201.141.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 120 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice. In the absence of an appropriate waiver, no officer or employee of the Commission engaged in the performance of investigative or prosecuting functions in this or any factually related proceeding will be permitted to participate or advise in the decision 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.

Brent J. Fields
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. 9996 / December 21, 2015

SECURITIES EXCHANGE ACT OF 1934
Release No. 76705 / December 21, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-17012

In the Matter of

KCG AMERICAS LLC

Respondent.

ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934, 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 Section 15(b) of the Securities Exchange Act of 1934 ("Exchange Act") against KCG Americas LLC ("Respondent").

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the "Offer") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 8A of the Securities Act of 1933 and Section 15(b) of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.

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## III.

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

### Summary

These proceedings arise out of Respondent's failure to seek to obtain best execution of certain customer orders. As a result of such failures, Respondent's representations to its customers that their orders were being handled consistent with best execution requirements were inaccurate.

### Respondent

1. Respondent KCG Americas LLC, headquartered in Jersey City, New Jersey, has been registered with the Commission as a broker-dealer since 2009. It is a subsidiary of Knight Capital Holdings LLC. Respondent acts as a market maker in various Over-the-Counter ("OTC") securities.

### Background

2. From at least 2010 to July 2013 (the "relevant period"), Respondent acted as a market maker in OTC securities, including securities quoted on OTC Link LLC ("OTC Link"), an inter-dealer quotation system formerly referred to as the "Pink Sheets."[1]

3. While serving as market maker, Respondent regularly receives orders that have been routed to it by its broker-dealer customers, for execution by Respondent.

4. During the relevant period, Respondent represented to its broker-dealer customers that it "recognizes its regulatory obligations to execute its broker-dealer clients' orders in a manner consistent with the requirements of the Best Execution Rule." Similarly, Respondent represented that it "will use its best efforts in connection with the handling of each of its client's orders."

5. As a market maker that quotes on OTC Link, Respondent has access to, and regularly uses, an electronic messaging service, formerly known as "Pink Link." During the relevant period, this electronic messaging service enabled Respondent and other individual market makers to send each other messages indicating an interest to buy or sell a specific number of shares of a security at a particular price. Such messages would be visible only to the sending and receiving firms.

6. If, as an example, Respondent received an OTC Link electronic message from a market maker offering to sell 5,000 shares of an OTC security at $.10 per share, and Respondent had an open customer limit order to purchase 5,000 shares at $.11 per share, Respondent's systems were properly set up to pass the $.10 price to the customer if Respondent accepted the offer from the other market maker and executed a trade opposite the market maker before filling the customer order. That is, if Respondent purchased 5,000 shares at $.10 from the messaging

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[1] OTC Link is also a registered broker-dealer and operates an alternative trading system.

market maker while the customer order was awaiting execution, and assuming no other orders in hand, the $.10 price would be passed along to the customer, who would receive a fill at $.10.

7. However, Respondent's systems inappropriately failed to protect certain customer orders in situations where both the OTC Link electronic message and a pending customer order were in hand simultaneously but Respondent filled the customer order first. Thus, in the prior example, assuming that Respondent had no other customer orders in hand, and assuming that the $.11 buy limit price was the current inside asking price at time of execution, the following might occur if Respondent were to fill the customer order first: Respondent could fill the customer order by selling 5,000 shares short or out of inventory to the customer at the $.11 limit price, followed by a purchase into inventory opposite the messaging market maker at the $.10 price. In that way, Respondent would fail to provide price improvement equal to the difference between the customer's limit price and the offer readily available to it through the OTC Link electronic messaging service, and would instead keep and profit from such difference.

8. In fact, that situation happened on numerous occasions during the relevant period, as illustrated by the following examples.

9. At 10:27:52 a.m. on March 12, 2010, Respondent received a customer order to sell 10,000 shares of an OTC security at a limit price of $0.17. Ten seconds later, at 10:28:02 a.m., Respondent received an electronic message through OTC Link indicating that another market maker was interested in buying at least 10,000 shares of the same security from Respondent at a price of $0.18. Eight seconds later, at 10:28:10 a.m., Respondent filled the entire customer order by buying 10,000 shares from the customer at a price of $0.17. Two seconds after that, at 10:28:12 a.m., Respondent sold 10,000 shares for itself to the messaging market maker at $0.18. Respondent failed to pass the $0.18 price to the customer for 10,000 shares, resulting in lost price improvement of $100, which Respondent kept as trading gains at the expense of the customer.

10. At 10:54:00 a.m. on February 10, 2011, Respondent received a customer order to buy 1,500 shares of an OTC security at a limit price of $3.80. Twenty-five seconds later, at 10:54:25 a.m., Respondent received an electronic message through OTC Link indicating that another market maker was interested in selling at least 500 shares of the same security to Respondent at a price of $3.70. Two seconds later, at 10:54:27 a.m., Respondent filled the entire customer order by selling 1,500 shares to the customer at a price of $3.73. Three seconds after that, at 10:54:30 a.m., Respondent purchased 500 shares for itself from the messaging market maker at $3.70. Respondent failed to pass the $3.70 price to the customer for 500 shares, resulting in lost price improvement of $15, which Respondent kept as trading gains at the expense of the customer.

11. At 13:46:29 p.m. on December 18, 2012, Respondent received an electronic message through OTC Link indicating that another market maker was interested selling at least 50,000 shares of an OTC security at a price of $0.025. At the time, Respondent was holding an open customer order to buy 19,600 shares of the same security at a limit price of $0.0255. At 13:46:36 p.m., Respondent filled the entire customer order by selling 19,600 shares to the customer at a price of $0.0255. Two seconds after that, at 13:46:38 p.m., Respondent purchased 50,000 shares for itself from the messaging market maker at $0.025. Respondent failed to pass the $0.025

price to the customer for the 19,600 shares, resulting in lost price improvement of $9.80, which Respondent kept as trading gains at the expense of the customer.

12. At 15:53:03 p.m. on February 6, 2013, Respondent received an electronic message through OTC Link indicating that another market maker was interested in selling at least 9,300 shares of an OTC security at a price of $2.11. Eight seconds later, at 15:53:11 p.m., Respondent received a customer order to buy 500 shares of the same security at a limit price of $2.12. One second later, at 15:53:12, Respondent filled the entire customer order at a price of $2.12. Two seconds after that, at 15:53:14, Respondent purchased 9,300 shares for itself from the messaging market maker at $2.11. Respondent failed to pass the $2.11 price to the customer for the 500 shares, resulting in lost price improvement of $5, which Respondent kept as trading gains at the expense of the customer.

13. By failing to pass on to certain customer orders more favorable available prices, Respondent breached its duty to seek to obtain best execution of customer orders, and caused its representations regarding order handling to be inaccurate with respect to those orders.

14. Although during the relevant period Respondent had in place various policies and procedures aimed at protecting customer orders and preventing or detecting possible violations of the firm's duty of best execution with respect to those orders, Respondent failed to implement reasonable procedures to address whether price opportunities available through OTC Link would be passed on to customers in circumstances where such price opportunities represented best execution.

15. In July 2013, during the course of the Commission's investigation into this conduct, Respondent voluntarily implemented new procedures governing the above situations, including supervisory procedures aimed at detecting any instances in which customer fills with respect to orders for securities quoted on OTC Link are not at or better than prices available through OTC Link. Respondent's current procedures now require that customers be notified of any such occurrences and be given the opportunity to either obtain cash compensation for the price difference or adjust the trade.

## Violations

16. As a result of the conduct described above, Respondent willfully[2] violated Section 17(a)(2) of the Securities Act, which prohibits obtaining money or property in the offer or sale of securities 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.

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2 A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

17. As result of the conduct described above, Respondent willfully violated Section 17(a)(3) of the Securities Act, which prohibits, in the offer or sale of securities, engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

**Respondent's Remedial Efforts**

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

**IV.**

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

Accordingly, pursuant to Section 8A of the Securities Act and Section 15(b) of the Exchange Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act.

B. Respondent is censured.

C. Respondent shall, within fifteen (15) days of the entry of this Order, pay disgorgement of $685,900, prejudgment interest of $69,297.38, and a civil money penalty of $300,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment of disgorgement and prejudgment interest is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600, and if timely payment of a civil money penalty 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 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 KCG Americas LLC 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 Andrew M. Calamari, Division of Enforcement, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, New York 10281.

By the Commission.

Brent J. Fields
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. 9997 / December 21, 2015**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76723 / December 21, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17013**

**In the Matter of**

**Allen M. Perres, and**
**Willard R. St. Germain**

**Respondents.**

**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933 AND SECTIONS 15(b) AND 21C OF THE SECURITIES EXCHANGE ACT OF 1934, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS AND CEASE-AND-DESIST ORDERS AND NOTICE OF HEARING**

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 8A of the Securities Act of 1933 ("Securities Act") and Sections 15(b) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against Allen M. Perres ("Perres") and Willard R. St. Germain ("St. Germain") (collectively, "Respondents").

## II.

In anticipation of the institution of these proceedings, Respondents have each submitted an Offer of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, and except as provided herein in Section VI, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933 and Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and Cease-and-Desist Orders and Notice of Hearing ("Order"), as set forth below:

## III.

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

**Respondents**

1. Allen M. Perres, age 68, resides in Chicago, Illinois. Perres serves as a marketer for Southern Cross Resources Group, Inc. ("Southern Cross"). Perres held the following securities licenses: Direct Participation Programs Limited Representative (Series 22) and Direct Participation Programs Principal (Series 39).

2. Willard R. St. Germain, age 71, lives in Wayne, Illinois. St. Germain serves as a marketer for Southern Cross. St. Germain held the following securities licenses: General Securities Representative (Series 7), General Securities Principal (Series 24), and Uniform Securities Agent State Law (Series 63).

**Other Relevant Entity and Persons**

3. Southern Cross is a Nevada corporation headquartered in Vernon Hills, Illinois. It was incorporated in 2014 as the successor to a 2007 Nevada corporation with the same name. Southern Cross purports to be an asset based trading company with a focus on energy producing assets.

4. Michael A. Nasatir ("Nasatir"), age 56, currently resides in Glenview, Illinois. Nasatir serves as the CEO of Southern Cross.

5. Andrew L. Madenberg ("Madenberg"), age 55, currently resides in Deerfield, Illinois. Madenberg serves as the President of Southern Cross.

**Southern Cross' Securities Offerings**

6. Nasatir and Madenberg entered into an agreement to acquire Southern Cross in April 2012. Southern Cross sold shares of its common stock and debt to investors from approximately April 2012 through approximately September 2014.

7. Through its offerings, Southern Cross raised a total of $5,120,587 from approximately 97 debt and equity investors, located in 12 states.

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

8. St. Germain and Perres acted as the marketers for Southern Cross and started earning commissions from the funds raised from investors beginning as early as April 2012 and continuing through at least September 2014.

9. During the relevant time period, St. Germain brought in at least 28 investors and received $223,836 in commissions and Perres brought in at least 10 investors and received $125,145 in commissions through the sale of common stock to investors. Together, they raised over $2 million for Southern Cross.

10. The amounts paid to St. Germain and Perres amounted to approximately 17% of the funds they raised from investors.

11. In addition to soliciting investors, St. Germain and Perres often provided investors with offering materials, including private placement memoranda and other informational brochures.

12. St. Germain and Perres often served as the primary sources of information for the investors and organized several meetings at a friend's business to pitch the company to potential investors.

13. St. Germain and Perres took no steps to determine whether any of the individuals who purchased shares of Southern Cross common stock through them were sophisticated or accredited investors.

14. St. Germain and Perres also did not provide the investors with access to registration-equivalent information about Southern Cross.

15. During the relevant time period, neither St. Germain nor Perres was registered with the Commission in any capacity or associated with a registered broker-dealer.

16. No registration statement was filed in connection with any of Southern Cross' securities, and no exemption from registration was applicable to any of the sales through St. Germain and Perres.

## Violations

17. As a result of the conduct described above, Respondents willfully violated Sections 5(a) and 5(c) of the Securities Act, which prohibit the direct or indirect offer and sale of securities through the mails or interstate commerce unless a registration

statement has been filed or is in effect or an exemption from registration is available.[2]

18. As a result of the conduct described above, Respondents willfully violated Section 15(a) of the Exchange Act, which prohibits any broker or dealer to use the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security without being registered with the Commission pursuant to Section 15(b) of the Exchange Act or being associated with a broker or dealer.

**Disgorgement and Civil Penalties**

19. Perres has submitted a sworn Statement of Financial Condition dated August 14, 2015 and other evidence and has asserted his inability to pay disgorgement plus prejudgment interest and a civil penalty.

20. St. Germain has submitted a sworn Statement of Financial Condition dated August 1, 2015 and other evidence and has asserted his inability to pay disgorgement plus prejudgment interest and a civil penalty.

**Undertakings**

21. In determining whether to accept the Respondents' Offers, the Commission has considered the following undertakings:

a. Respondent Perres agrees to cooperate fully with the Commission with respect to this action and any judicial or administrative proceeding or investigation commenced by the Commission or to which the Commission is a party relating to the matters in this Order or other matters related to Southern Cross' securities or officers. Respondent Perres' cooperation shall include, but is not limited to:

    i. Production of Information. At the Commission's request on reasonable notice and without a subpoena, Respondent Perres shall truthfully and completely disclose information and documents requested by Commission staff in connection with the Commission's related investigation, litigation or other proceedings. Respondent Perres will have no obligation to provide information voluntarily that he is not able to provide without a subpoena.

[2] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (*quoting Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (*quoting Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

ii. Statements and Testimony. At the Commission's request on reasonable notice and without a subpoena, Respondent Perres shall attend and provide truthful statements or testimony at any meeting, interview, testimony, deposition, trial or other legal proceeding in connection with the Commission's related investigation, litigation or other proceedings.

b. Respondent St. Germain agrees to cooperate fully with the Commission with respect to this action and any judicial or administrative proceeding or investigation commenced by the Commission or to which the Commission is a party relating to the matters in this Order or other matters related to Southern Cross' securities or officers. Respondent St. Germain's cooperation shall include, but is not limited to:

i. Production of Information. At the Commission's request on reasonable notice and without a subpoena, Respondent St. Germain shall truthfully and completely disclose information and documents requested by Commission staff in connection with the Commission's related investigation, litigation or other proceedings. Respondent St. Germain will have no obligation to provide information voluntarily that he is not able to provide without a subpoena.

ii. Statements and Testimony. At the Commission's request on reasonable notice and without a subpoena, Respondent St. Germain shall attend and provide truthful statements or testimony at any meeting, interview, testimony, deposition, trial or other legal proceeding in connection with the Commission's related investigation, litigation or other proceedings.

**IV.**

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

Accordingly, pursuant to Section 8A of the Securities Act and Section 15(b) and 21C of the Exchange Act, it is hereby ORDERED that:

A. Respondent Perres

1. Respondent Perres cease and desist from committing or causing any violations and any future violations of Sections 5(a) and 5(c) of the Securities Act and Section 15(a) of the Exchange Act;

2. Respondent Perres shall pay disgorgement of $125,145 which represents profits gained as a result of the conduct described herein, and prejudgment interest of $8,805, but that payment of such amount except for $31,284 is waived and the Commission is not imposing a civil penalty based on Perres' sworn representations in his Statement of Financial Condition dated August 14, 2015 and other documents submitted to the Commission. The payment required by this Order shall be made to the Securities and Exchange Commission. The Commission will hold funds paid pursuant to this paragraph in an account at the United States Treasury pending a decision whether the Commission, in its discretion, will seek to distribute funds or, transfer them to the general fund of the United States Treasury, subject to Section 21F(g)(3).

Payment shall be made in the following installments:

(1) $2,607 no later than the last day of each quarter beginning in March 2016 and continuing through December 2018.

If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of disgorgement, plus any additional interest accrued pursuant to SEC Rule of Practice 600, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

(1) Respondent Perres may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondent Perres 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 Perres 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 Allen Perres 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 Anne C. McKinley, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, Chicago Regional Office, 175 West Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

3. Based upon Respondent Perres' sworn representations in his Statement of Financial Condition dated August 14, 2015 and other documents submitted to the Commission, the Commission is not imposing a penalty against Respondent Perres.

IT IS FURTHER ORDERED, pursuant to Rule 100(c) of the Commission's Rules of Practice, 17 C.F.R. § 201.100(c), in the interest of justice and without prejudice to any party to the proceeding, that a public hearing for the purpose of taking evidence on the questions set forth in Section V hereof shall be convened at a time and place to be fixed by, 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.

If Respondent Perres fails to appear at a hearing after being duly notified, he 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), 221(f), and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.221(f), and 201.310.

This Order shall be served forthwith upon Respondent Perres as provided for in the Commission's Rules of Practice.

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.

B. <u>Respondent St. Germain</u>

1. Respondent St. Germain cease and desist from committing or causing any violations and any future violations of Sections 5(a) and 5(c) of the Securities Act and Section 15(a) of the Exchange Act;

2. Respondent St. Germain 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

with the right to apply for reentry after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

3. Any reapplication for association by Respondent St. Germain 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.

4. Respondent St. Germain shall pay disgorgement of $223,836 which represents profits gained as a result of the conduct described herein, and prejudgment interest of $14,071, but that payment of such amount except for $55,956 is waived and the Commission is not imposing a civil penalty based on Respondent St. Germain's sworn representations in his Statement of Financial Condition dated August 1, 2015 and other documents submitted to the Commission. The payment required by this Order shall be made to the Securities and Exchange Commission. The Commission will hold funds paid pursuant to this paragraph in an account at the United States Treasury pending a decision whether the Commission, in its discretion, will seek to distribute funds or, transfer them to the general fund of the United States Treasury, subject to Section 21F(g)(3).

Payment shall be made in the following installments:

(1) $4,663 no later than the last day of each quarter beginning in March 2016 and continuing through December 2018.

If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of disgorgement, plus any additional interest accrued pursuant to SEC Rule of Practice 600, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

(1) Respondent St. Germain may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) Respondent St. Germain 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 St. Germain 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 Willard St. Germain 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 Anne C. McKinley, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, Chicago Regional Office, 175 West Jackson Boulevard, Suite 900, Chicago, Illinois 60604.

5. Based upon Respondent St. Germain's sworn representations in his Statement of Financial Condition dated August 1, 2015 and other documents submitted to the Commission, the Commission is not imposing a penalty against Respondent St. Germain.

C. The Division of Enforcement ("Division") may, at any time following the entry of this Order, petition the Commission to: (1) reopen this matter to consider whether Respondents provided accurate and complete financial information at the time such representations were made; (2) seek an order directing payment of disgorgement and pre-judgment interest; and (3) 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 Respondents was fraudulent, misleading, inaccurate, or incomplete in any material respect. Respondents 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.

## V.

Pursuant to this Order, Respondent Perres agrees to additional proceedings in this proceeding to determine what, if any, additional non-financial remedial sanctions against Respondent Perres pursuant to Section 15(b)(6) of the Exchange Act are in the public interest. In connection with such additional proceedings: (a) Respondent Perres agrees that he will be precluded from arguing that he did not violate the federal securities laws as described in this Order; (b) Respondent Perres agrees that he may not challenge the validity of this Order; (c) solely for the purposes of such additional proceedings, the findings of this Order shall be accepted as and deemed true by the hearing officer; and (d) the hearing officer may determine the issues raised in the additional proceedings on the basis of affidavits, declarations, excerpts of sworn deposition or investigative testimony, and documentary evidence.

**VI.**

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

**VII.**

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.

Brent J. Fields
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. 76702/December 21, 2015

INVESTMENT ADVISERS ACT OF 1940
Release No. 4296/December 21, 2015

Admin. Proc. File No. 3-16294

In the Matter of

PHILLIP DENNIS MURPHY

**ORDER VACATING NATIONALLY RECOGNIZED STATISTICAL RATING ORGANIZATION AND MUNICIPAL ADVISOR BARS**

Phillip Dennis Murphy seeks to vacate an administrative bar order dated December 31, 2014 ("bar order") to the extent that it bars him from association with any nationally recognized statistical rating organization ("NRSRO") or any municipal advisor.[1] The NRSRO and municipal advisor bars imposed on Phillip Dennis Murphy were based solely on conduct occurring prior to July 22, 2010, the effective date of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] Accordingly, in our discretion, we vacate the bar order to the extent that it prohibits Phillip Dennis Murphy from associating with any NRSRO or any municipal advisor, but otherwise leave the bar unchanged.

By the Commission.

Brent J. Fields
Secretary

By: Lynn M. Powalski
Deputy Secretary

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1 *See Phillip Dennis Murphy*, Advisers Act Release No. 3992, 2014 WL 7407484 (Dec. 31. 2014).

2 *See generally Koch v. SEC*, 793 F.3d 147 (D.C. Cir. 2015).

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 4297 / December 21, 2015

Admin. Proc. File No. 3-16336

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| In the Matter of<br><br>GUY ANDREW WILLIAMS |

ORDER MODIFYING SANCTIONS AND NOTICE THAT INITIAL DECISION, AS MODIFIED, HAS BECOME FINAL

The time for filing a petition for review of the initial decision in this proceeding has expired. Respondent Guy Andrew Williams ("Williams") did not file a petition for review. The Commission has, on its own initiative, decided to review the initial decision for the limited purpose of reviewing and setting aside the municipal advisor and nationally recognized statistical rating organization ("NRSRO") bars. In all other respects, the initial decision of the law judge is the final decision of the Commission.

On June 3, 2015, the administrative law judge issued an initial decision with respect to Williams.[1] The law judge found that respondent was in default. The initial decision ordered that, pursuant to Section 203(f) of the Investment Advisers Act of 1940, Williams is permanently barred from associating with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or NRSRO.

The municipal advisor and NRSRO bars imposed on Williams were based solely on conduct occurring prior to July 22, 2010, the effective date of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] Accordingly, in our discretion, we set aside the

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1 *Guy Andrew Williams,* Initial Decision Release No. 805, 111 SEC Docket 13, 2015 WL 3505303 (June 3, 2015).

2 *See generally Koch v. SEC,* 793 F.3d 147 (D.C. Cir. 2015).

law judge's initial decision to the extent that it prohibits Williams from associating with any NRSRO or any municipal advisor. We otherwise leave the initial order unchanged, and pursuant to Rule 360(d) of the Commission's Rules of Practice,[3] give notice that the initial decision of the law judge, as modified above, is the final decision of the Commission.

By the Commission.

Brent J. Fields
Secretary

By: Lynn M. Powalski
Deputy Secretary

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3 17 C.F.R. § 201.360(d).

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 4298 / December 21, 2015

Admin. Proc. File No. 3-16335

In the Matter of

DUANE HAMBLIN SLADE

ORDER MODIFYING SANCTIONS AND NOTICE THAT INITIAL DECISION, AS MODIFIED, HAS BECOME FINAL

The time for filing a petition for review of the initial decision in this proceeding has expired. Respondent Duane Hamblin Slade ("Slade") did not file a petition for review. The Commission has, on its own initiative, decided to review the initial decision for the limited purpose of reviewing and setting aside the municipal advisor and nationally recognized statistical rating organization ("NRSRO") bars. In all other respects, the initial decision of the law judge is the final decision of the Commission.

On May 26, 2015, the administrative law judge issued an initial decision with respect to Slade.[1] The initial decision ordered that, pursuant to Section 203(f) of the Investment Advisers Act of 1940, Slade be permanently barred from associating with an investment adviser, broker, dealer, municipal securities dealer, municipal advisor, transfer agent, or NRSRO.

The municipal advisor and NRSRO bars imposed on Duane Hamblin Slade were based solely on conduct occurring prior to July 22, 2010, the effective date of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] Accordingly, in our discretion, we set aside the law judge's initial decision to the extent that it prohibits Slade from associating with any

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1 *Duane Hamblin Slade,* Initial Decision Release No. 799 111 SEC Docket 12, 2015 WL 2457670 (May 26, 2015).

2 *See Koch v. SEC,* 793 F3d 147 (D.C. Cir. 2015).

NRSRO or any municipal advisor. We otherwise leave the initial order unchanged, and pursuant to Rule 360(d) of the Commission's Rules of Practice,[3] give notice that the initial decision of the law judge, as modified above, is the final decision of the Commission.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

[3] 17 C.F.R. § 201.360(d).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 76720 / December 21, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-15393

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| In the Matter of<br><br>COMPREHENSIVE CAPITAL MANAGEMENT, INC.,<br><br>Respondent. | ORDER DIRECTING DISBURSEMENT OF FAIR FUND |

On May 7, 2015, the Securities and Exchange Commission ("Commission") published a Notice of Proposed Plan of Distribution Transferring Fair Fund Funds to a Court-Appointed Receiver and Opportunity for Comment[1] ("Notice") pursuant to Rule 1103 of the Commission's Rules on Fair Fund and Disgorgement Plans ("Commission's Rules").[2] The Notice advised interested persons that they could obtain a copy of the proposed plan of distribution ("Distribution Plan") from the Commission's public website at http://www.sec.gov/litigation/fairfundlist.htm or by submitting a written request to Nancy Chase Burton, United States Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-5631. The Notice also advised that all persons desiring to comment on the Distribution Plan could submit their comments, in writing, no later than thirty (30) days from the date of the Notice: (1) to the Office of the Secretary, United States Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090; (2) by using the Commission's Internet comment form (http://www.sec.gov/litigation/admin.shtml); or (3) by sending an e-mail to rule-comments@sec.gov. No comments were received, and subsequently, on June 23, 2015, the Commission issued an Order Approving Plan of Distribution.[3]

The Distribution Plan provides that once the plan is approved by the Commission, Commission staff will take the necessary steps to obtain a Commission order transferring the Comprehensive Capital Management, Inc. ("CCM") Fair Fund, pursuant to Rule 1102(a) of the Commission's Rules,[4] to a court-appointed receiver in the related Commission action, *SEC v. Roth, et al.*, Case No. 11-cv-2079 (C.D. Ill.) (the "Receiver Action"). The receiver will then distribute the CCM Fair Fund to injured investors in accordance with the distribution plan to be established in the Receiver Action. The receiver has determined that the CCM Fair Fund will be distributed *pro rata* to seven injured investors and has provided the amount each injured investor will receive to Commission staff. Commission staff has reviewed this

[1] Exchange Act Release No. 74899 (May 7, 2015).
[2] 17 C.F.R. § 201.1103.
[3] Exchange Act Release No. 75264 (June 23, 2015).
[4] 17 C.F.R. § 201.1102(a).

material, and requests that the Commission authorize the transfer of the CCM Fair Fund to the receiver for distribution.

Accordingly, it is hereby ORDERED that Commission staff shall disburse the entire CCM Fair Fund to the receiver's bank account established in the Receiver Action, for distribution pursuant to the receiver's distribution plan to the seven injured investors identified by the receiver.

By the Commission.

Brent J. Fields
Secretary

By: Lynn M. Powalski
Deputy Secretary

**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**December 22, 2015**

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| **In the Matter of**<br><br>**Bravo Resource Partners, Ltd.,**<br>**First Potash Corp.,**<br>**HIP Energy Corporation,**<br>**Musgrove Minerals Corp., and**<br>**Starcore International Ventures Ltd.**<br>**(a/k/a Starcore International Mines Ltd.),**<br><br>**File No. 500-1** | **ORDER OF SUSPENSION OF TRADING** |

It appears to the Commission that there is a lack of current and accurate information concerning the securities of Bravo Resource Partners, Ltd. ("BRPNF") (CIK No. 1116137), a Yukon corporation located in Englewood, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g) because it is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended October 31, 2011. On April 22, 2015, Corporation Finance sent a delinquency letter to BRPNF requesting compliance with its periodic filing requirements but BRPNF did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common stock of BRPNF was quoted on OTC Link, had two market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

It appears to the Commission that there is a lack of current and accurate information concerning the securities of First Potash Corp. ("SALTF") (CIK No. 1490078), a British Columbia corporation located in Tucson, Arizona with a class of securities registered with the

Commission pursuant to Exchange Act Section 12(g) because it is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended February 29, 2012. On April 28, 2015, Corporation Finance sent a delinquency letter to SALTF requesting compliance with its periodic filing requirements but SALTF did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common shares of SALTF were quoted on OTC Link, had four market makers, and were eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

It appears to the Commission that there is a lack of current and accurate information concerning the securities of HIP Energy Corporation ("HIPCF") (CIK No. 1123839), a British Columbia corporation located in West Vancouver, BC, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g) because it is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended November 30, 2011. On April 15, 2014, Corporation Finance sent a delinquency letter to HIPCF requesting compliance with its periodic filing requirements but HIPCF did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common shares of HIPCF were quoted on OTC Link, had four market makers, and were eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

It appears to the Commission that there is a lack of current and accurate information concerning the securities of Musgrove Minerals Corp. ("MGSGF") (CIK No. 1396368), a British

Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g) because it is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended November 30, 2007. On April 28, 2015, Corporation Finance sent a delinquency letter to MGSGF requesting compliance with its periodic filing requirements but MGSGF did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common shares of MGSGF were quoted on OTC Link, had four market makers, and were eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

It appears to the Commission that there is a lack of current and accurate information concerning the securities of Starcore International Ventures Ltd. (a/k/a Starcore International Mines Ltd.) ("SHVLF") (CIK No. 1301713), a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g) because it is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-FR-12G on August 31, 2004. On February 19, 2015, Corporation Finance sent a delinquency letter to SHVLF requesting compliance with its periodic filing requirements but SHVLF did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common shares of SHVLF were quoted on OTC Link, had seven market makers, and were eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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. EST on December 22, 2015, through 11:59 p.m. EST on January 6, 2016.

By the Commission.

Brent J. Fields
Secretary

By: Jill M. Peterson
Assistant Secretary

**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**December 22, 2015**

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| **In the Matter of**<br><br>**Bioject Medical Technologies, Inc.,**<br>**Black Castle Developments Holdings, Inc. (n/k/a ingXabo Corporation),**<br>**Catalyst Resource Group, Inc.,**<br>**SSI International, Ltd.,**<br>**Strike Axe, Inc., and**<br>**Viper Powersports, Inc.,**<br><br>**File No. 500-1** | **ORDER OF SUSPENSION OF TRADING** |

It appears to the Securities and Exchange Commission ("Commission") that there is a lack of current and accurate information concerning the securities of Bioject Medical Technologies, Inc. ("BJCT[1]") (CIK No. 810084), an Oregon corporation located in Tigard, Oregon with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g) because it 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, 2011. On April 28, 2015, the Commission's Division of Corporation Finance ("Corporation Finance") sent a delinquency letter to BJCT requesting compliance with its periodic filing requirements but BJCT did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common stock of BJCT was quoted on OTC Link operated by OTC Markets Group Inc.

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

(formerly "Pink Sheets") ("OTC Link"), had ten market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

It appears to the Commission that there is a lack of current and accurate information concerning the securities of Black Castle Developments Holdings, Inc. (n/k/a ingXabo Corporation) ("BCDH") (CIK No. 1072971), a Nevada corporation located in Fresno, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g) because it is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-12G on April 16, 2012. On February 19, 2015, Corporation Finance sent a delinquency letter to BCDH requesting compliance with its periodic filing requirements but BCDH did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common stock of BCDH was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

It appears to the Commission that there is a lack of current and accurate information concerning the securities of Catalyst Resource Group, Inc. ("CATA") (CIK No. 106311), a Florida corporation located in Huntington Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g) because it 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, 2012. On February 19, 2015, Corporation Finance sent a delinquency letter to CATA requesting compliance with its periodic filing requirements but CATA did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common stock of CATA was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

It appears to the Commission that there is a lack of current and accurate information concerning the securities of SSI International, Ltd. ("SSIT") (CIK No. 1455982), a revoked Nevada corporation located in Reno, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g) because it 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 October 31, 2011. On February 19, 2015, Corporation Finance sent a delinquency letter to SSIT requesting compliance with its periodic filing requirements but SSIT did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common stock of SSIT was quoted on OTC Link, had three market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

It appears to the Commission that there is a lack of current and accurate information concerning the securities of Strike Axe, Inc. ("SKAX") (CIK No. 1438945), a void Delaware corporation located in Lombard, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g) because it 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 August 31, 2012. On April 28, 2015, Corporation Finance sent a delinquency letter to SKAX requesting compliance with its periodic filing requirements but SKAX did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common stock of SKAX was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

It appears to the Commission that there is a lack of current and accurate information concerning the securities of Viper Powersports, Inc. ("VPWI") (CIK No. 1337213), a defaulted Nevada corporation located in Auburn, Alabama with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g) because it is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 2012. On April 22, 2015, Corporation Finance sent a delinquency letter to VPWI requesting compliance with its periodic filing requirements but VPWI did not receive the delinquency letter due to its failure to maintain a valid address on file with the Commission as required by Commission rules (Rule 301 of Regulation S-T, 17 C.F.R. Section 232.301 and Section 5.4 of EDGAR Filer Manual). As of December 9, 2015, the common stock of VPWI was quoted on OTC Link, had eight market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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. EST on December 22, 2015, through 11:59 p.m. EST on January 6, 2016.

By the Commission.

Brent J. Fields
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. 76726 / December 22, 2015

ADMINISTRATIVE PROCEEDING
File No. 3-17014

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|---|---|
| In the Matter of<br><br>Bravo Resource Partners, Ltd.,<br>First Potash Corp.,<br>HIP Energy Corporation,<br>Musgrove Minerals Corp., and<br>Starcore International Ventures Ltd.<br>(a/k/a Starcore International Mines Ltd.),<br><br>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]

1. Bravo Resource Partners, Ltd. ("BRPNF") (CIK No. 1116137) is a Yukon corporation located in Englewood, Colorado with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BRPNF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-Q for the period ended October 31, 2011, which reported a net loss of $18,542 for the prior three months. As of December 9, 2015, the common stock of BRPNF was quoted on OTC Link operated by OTC Markets Group Inc. (formerly "Pink Sheets") ("OTC Link"), had two market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

2. First Potash Corp. ("SALTF") (CIK No. 1490078) is a British Columbia corporation located in Tucson, Arizona with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). SALTF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended February 29, 2012, which reported a net loss of $977,249 Canadian for the prior year. As of December 9, 2015, the common shares of SALTF were quoted on OTC Link, had four market makers, and were eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

3. HIP Energy Corporation ("HIPCF") (CIK No. 1123839) is a British Columbia corporation located in West Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). HIPCF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended November 30, 2011, which reported a net loss of $668,208 for the prior year. As of December 9, 2015, the common shares of HIPCF were quoted on OTC Link, had four market makers, and were eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. Musgrove Minerals Corp. ("MGSGF") (CIK No. 1396368) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). MGSGF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-F for the period ended November 30, 2007, which reported a net loss of $2,362,986 Canadian for the prior year. As of December 9, 2015, the common shares of MGSGF were quoted on OTC Link, had four market makers, and were eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. Starcore International Ventures Ltd. (a/k/a Starcore International Mines Ltd.) ("SHVLF") (CIK No. 1301713) is a British Columbia corporation located in Vancouver, British Columbia, Canada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). SHVLF is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 20-FR-12G on August 31, 2004, which reported a net loss of $116,388 Canadian for the nine months ended April 30, 2004. As of December 9, 2015, the common shares of SHVLF were quoted on OTC Link, had seven market makers, and were 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.

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

Brent J. Fields
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. 76728 / December 22, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17015**

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| **In the Matter of**<br><br>**Bioject Medical Technologies, Inc.,**<br>**Black Castle Developments Holdings, Inc. (n/k/a ingXabo Corporation),**<br>**Catalyst Resource Group, Inc.,**<br>**SSI International, Ltd.,**<br>**Strike Axe, Inc., and**<br>**Viper Powersports, Inc.,**<br><br>**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]

1. Bioject Medical Technologies, Inc. ("BJCT") (CIK No. 810084) is an Oregon corporation located in Tigard, Oregon with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BJCT 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, 2011. As of December 9, 2015, the common stock of BJCT was quoted on OTC Link operated by OTC Markets Group Inc. (formerly "Pink Sheets") ("OTC Link"), had

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

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ten market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

2. Black Castle Developments Holdings, Inc. (n/k/a ingXabo Corporation) ("BCDH") (CIK No. 1072971) is a Nevada corporation located in Fresno, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). BCDH is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-12G on April 16, 2012,which reported a net loss of $682,717 for the year ended December 31, 2011. As of December 9, 2015, the common stock of BCDH 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. Catalyst Resource Group, Inc. ("CATA") (CIK No. 106311) is a Florida corporation located in Huntington Beach, California with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CATA 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, 2012, which reported a net loss of $177,655 for the prior six months. As of December 9, 2015, the common stock of CATA was quoted on OTC Link, had seven market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

4. SSI International Ltd. ("SSIT") (CIK No. 1455982) is a revoked Nevada corporation located in Reno, Nevada with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). SSIT 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 October 31, 2011, which reported a net loss of $30,216 for the prior year. As of December 9, 2015, the common stock of SSIT was quoted on OTC Link, had three market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

5. Strike Axe, Inc. ("SKAX") (CIK No. 1438945) is a void Delaware corporation located in Lombard, Illinois with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). SKAX 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 August 31, 2012, which reported a net loss of $103,407 for the prior six months. As of December 9, 2015, the common stock of SKAX was quoted on OTC Link, had four market makers, and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

6. Viper Powersports, Inc. ("VPWI") (CIK No. 1337213) is a revoked Nevada corporation located in Auburn, Alabama with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). VPWI is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-K for the period ended December 31, 2012, which reported a net loss attributable to common shareholders of $6,109,151 for the prior year. As of December 9, 2015, the common stock of VPWI 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

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, Exchange Act Rule 13a-1 requires issuers to file annual reports, and Exchange Act Rule 13a-13 requires 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.

Brent J. Fields
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. 9998 / December 22, 2015**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76729 / December 22, 2015**

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 4299 / December 22, 2015**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 31947 / December 22, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17016**

**In the Matter of**

**MORGAN STANLEY INVESTMENT MANAGEMENT INC. and SHEILA HUANG**

**Respondents.**

**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 8A OF THE SECURITIES ACT OF 1933, SECTION 21C OF THE SECURITIES EXCHANGE ACT OF 1934, SECTIONS 203(e), 203(f) AND 203(k) OF THE INVESTMENT ADVISERS ACT OF 1940, AND 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**

## 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 203(e) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), and Sections 9(b) and 9(f) of the Investment Company Act of 1940 ("Investment Company Act") against Morgan Stanley Investment Management Inc. ("MSIM"), and pursuant to Section 8A of the Securities Act, Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), Sections 203(f) and 203(k) of the Advisers Act and Section 9(b) of the Investment Company Act against Sheila Huang ("Huang") (together "Respondents").

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## II.

In anticipation of the institution of these proceedings, Respondents have submitted Offers of Settlement (the "Offers") which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission's jurisdiction over them and the subject matter of these proceedings, which are admitted, and except as provided herein in Section V, Respondents consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934, Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, and 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.

## III.

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

**Summary**

1. These proceedings concern a series of unlawful prearranged trades conducted by a portfolio manager/trader formerly employed by registered investment adviser MSIM which resulted in the undisclosed favorable treatment of certain MSIM advisory clients over others, in violation of MSIM's fiduciary duties to those clients. The prearranged trades involve MSIM and a former MSIM portfolio manager/trader, Sheila Huang, on one side of the trades, and a registered broker-dealer, SG Americas Securities, LLC ("SGAS") and a former SGAS trader, Yimin Ge ("Ge"), on the other side of the trades. From late 2011 through early 2012, Huang engaged in a series of unlawful prearranged sales and buybacks of fixed-income securities with Ge. While effecting sales for accounts that needed to liquidate certain positions, Huang did not simply sell them into the open market or to other accounts advised by MSIM in accordance with the firm's cross trade rules. Instead, Huang sold to and improperly prearranged a repurchase from SGAS at predetermined prices that were based on the initial sale price plus a minimal markup in order to "buyback" the positions into other accounts advised by MSIM. By engaging in trades between advisory accounts in this manner, she violated the antifraud provisions of the federal securities laws. In addition, by interposing SGAS to effectuate these cross trades, Huang evaded MSIM's internal cross trade requirements and as a result, in certain instances, caused violations of regulatory prohibitions on cross trades.

2. For the first five sets of trades, the manner in which Huang effectuated the prearranged cross trades resulted in undisclosed favorable treatment to the purchasing client, which was often a certain unregistered fund sponsored and advised by MSIM ("Unregistered Fund").

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

Specifically, Huang arranged to sell the bonds to SGAS at the highest current independent bid price available for the securities, and executed the repurchase side of the cross trade at a small markup over the sales price. For these sets of trades, by not crossing these positions at the midpoint between best bid and offer, Huang generally allocated the full benefit of the market savings to its purchasing clients, even though both purchasing and selling clients were owed the same fiduciary duty. As a result of this conduct, Huang willfully violated Sections 17(a)(1) and (3) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-5(a) and (c) thereunder, and willfully aided and abetted and caused violations of Sections 206(1) and (2) of the Advisers Act. Also as a result of Huang's conduct, MSIM willfully violated Section 17(a)(3) of the Securities Act and Section 206(2) of the Advisers Act. In addition, because Huang crossed two securities from accounts for two registered investment companies ("RICs") to one RIC-affiliated client account, MSIM aided and abetted and caused the violation of Section 17(a)(2) of the Investment Company Act.

3. The conduct related to the sixth set of prearranged trades resulted in undisclosed favorable treatment to the selling clients and disadvantaged the Unregistered Fund. Huang and MSIM became aware that non-investment grade mortgage bonds had been purchased for certain accounts subject to the Employee Retirement Income Security Act of 1974 ("ERISA") and that these may have been prohibited purchases for those accounts (MSIM ultimately concluded that the purchases were not prohibited). Huang also became aware that the ERISA accounts would incur a loss if the positions were sold. To avoid incurring a loss to the ERISA accounts, Huang orchestrated a scheme to sell those bonds at above-market prices to SGAS and, at the same time, sold two bonds from the Unregistered Fund to SGAS at below market prices for no legitimate business purpose in order to offset the above market prices of the bonds she was selling from the ERISA accounts. At the time of the sale to SGAS, Huang prearranged their repurchase by the Unregistered Fund. She repurchased bonds that had come from the ERISA accounts at slight markups from the sales prices, thus moving approximately $600,000 in previously unrealized losses from the ERISA accounts to the Unregistered Fund. She repurchased the two bonds that had come from the Unregistered Fund at the same prices at which they were sold. As a result of this conduct, Huang willfully violated Sections 17(a)(1) and (3) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-5(a) and (c) thereunder, and willfully aided and abetted and caused violations of Sections 206(1) and (2) of the Advisers Act. Also as a result of Huang's conduct, MSIM willfully violated Section 17(a)(3) of the Securities Act and Section 206(2) of the Advisers Act.

4. MSIM failed to adopt adequate policies and procedures to prevent unlawful cross trading effectuated by Huang through these transactions with SGAS, and thus violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. MSIM also failed reasonably to supervise Huang within the meaning of Section 203(e)(6) of the Advisers Act.

## Respondents

5. **Morgan Stanley Investment Management Inc.** is a Delaware corporation with its principal place of business in New York, New York. It is an investment adviser registered with the Commission and had between approximately $175 to $250 billion in assets under management from 2011 through 2014. Its clients include multiple registered investment companies, pooled

investment vehicles and separately managed accounts. It is wholly owned by Morgan Stanley, a public company.

6. **Sheila Huang** is 47 years old and a resident of New York. She was employed by MSIM starting in 2008 and was a Managing Director from 2010 until her departure from the firm in mid-2014. During the relevant time period she was the head of Mortgages (or the "Mortgage Team") at MSIM, responsible for mortgage-backed and asset-backed securities trading and investment strategy. She was the lead portfolio manager for the Unregistered Fund.

## Other Relevant Entity

7. **SG Americas Securities, LLC** is a broker-dealer registered with the Commission and is headquartered in New York, New York. It is 100% owned by Societe Generale, a foreign bank headquartered in Paris, France, indirectly through SG Americas Securities Holdings, LLC. SGAS and Ge are named as respondents in separate administrative and cease-and-desist proceedings relating to their conduct described in this Order.

## Facts

8. MSIM's Mortgage Team consisted of mortgage-backed and asset-backed securities traders and analysts. As head of MSIM's Mortgage Team, Huang was responsible for mortgage-backed and asset-backed securities trading and investment decisions for MSIM's advisory clients. The six sets of unlawful prearranged trades at issue were proposed by Huang and agreed to by Ge without any arm's length negotiation.

9. Each set of MSIM/SGAS sell-buy trade pairs involved a package of bonds which were sold to SGAS and then repurchased by MSIM the next business day at the same price they were sold plus a small markup. There were a total of 81 individual positions traded in the six trades between MSIM and SGAS, which consisted of collateralized mortgage obligations ("CMOs"), commercial mortgage back securities ("CMBS"), and asset backed securities ("ABS").

10. In the "buyback" trades that are at issue, Huang typically offered the positions to Ge at the best bid received from other broker-dealers and indicated that the bonds would be bought back at a small markup. Through this arrangement, Huang was able to repurchase positions at a price only slightly above the bid price, which was a more favorable price to the buying accounts than transacting at a price that incorporated the full market based bid-offer spread for these types of securities.

11. In each set of buyback trades, none of which was negotiated at arm's length, there was an understanding between Huang and Ge that the positions would be repurchased at a slight markup. Huang and Ge expected the other to follow through with a reoffer and repurchase the next business day with a small markup. The understanding was that the securities would be temporarily held by SGAS, and that SGAS would be made whole on the buyback and would receive a slight markup.

12. Huang and Ge agreed to an identical markup across all positions reoffered, regardless of the individual characteristics or sizes of the positions. The small markup was primarily determined by the dollar amount required to cover SGAS's ticketing costs.

13. For the six sets of trades with SGAS between December 2011 and March 2012, Huang and the Mortgage Team, at Huang's direction, used "buyback" arrangements to cross bonds between accounts, rather than using MSIM's cross trade procedure as required by MSIM's policies. The prearranged nature of the six sets of buyback trades meant that risk never truly passed to SGAS. In practice, Huang was simply interposing SGAS to effect cross trades and avoid MSIM and regulatory requirements governing cross trades.

**a. Cross Trading Regulations and MSIM Policies**

14. Sections 17(a)(1) and 17(a)(2) of the Investment Company Act generally prohibit any affiliated person of a RIC or any affiliated person of the affiliated person, acting as principal, from knowingly selling a security to, or purchasing a security from the RIC unless the person first obtains an exemptive order from the Commission under Section 17(b).

15. Rule 17a-7 under the Investment Company Act exempts from these prohibitions certain purchases and sales between a RIC and its affiliated person where the affiliation arises solely because the two have a common investment adviser, directors and/or officers, provided that the transactions are effected in accordance with Rule 17a-7. Rule 17a-7 requires, among other things, that cross trades be executed at the "independent current market price," which, in relevant part, is defined as "the average of the highest current independent bid and lowest current independent offer, determined on the basis of reasonable inquiry." If the adviser pays a brokerage commission, fee, or other remuneration in connection with cross transactions, the transaction is not eligible for an exemption under Rule 17a-7.

16. The Commission has stated that interpositioning a dealer in cross transactions does not remove the cross transactions from the prohibitions of Section 17(a), and has emphasized that "to the extent these transactions are effected at the 'bid' or 'asked' price rather than at an average of the two prices, they would not be in compliance with the rule's pricing requirements." *See* Section 48(a) of the Investment Company Act; *Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof*, Investment Company Act Rel. No. 11136, at n.10 (Apr. 21, 1980) (the "17a-7 Release").

17. The Employee Retirement Income Security Act of 1974 ("ERISA"), as amended, also prohibits investment advisers, as fiduciaries, from engaging in cross trades with ERISA regulated accounts. *See* ERISA Section 406(b) (29 U.S.C. § 1106(b)). ERISA provides an exemption from the prohibition if, among other conditions, the transaction is effected at the independent current market price of the security, within the meaning of Rule 17a-7(b) under the Investment Company Act. *See* ERISA Section 408(b)(19)(B) (29 U.S.C. § 1108(b)(19)(B)).

18. MSIM's internal cross trading policies and procedures provided for even broader restrictions on trade execution. MSIM's policies prohibited cross trades involving ERISA accounts under any circumstances. MSIM's compliance manual required all other cross trades to be executed in compliance with Rule 17a-7, regardless of whether the accounts were RICs.

19. MSIM's compliance policies also addressed its best execution duties, specifying that MSIM must "use best efforts to obtain 'best execution' for all client transactions (i.e., the most favorable price and execution)." When executing trades, MSIM's policies required traders to obtain at least two additional comparable dealer quotes and document those quotes to evidence best execution. For cross trades, MSIM's procedures generally required traders to obtain at least three dealer quotes to determine the highest current independent bid and lowest current independent offer. During the relevant time period, the comparable quotes were required to be documented in MSIM's recordkeeping systems.

20. While MSIM had policies and procedures addressing wrongful conduct, MSIM did not have policies specifically addressing "parking" or prearranged trading, and did not conduct training on these specific topics during the relevant period.

**b. First Five MSIM/SGAS Unlawful Prearranged Trade Sets**

21. Huang placed the first five sets of buyback trades from December 2011 through February 2012 because certain MSIM client accounts wanted to liquidate certain mortgage securities and other asset backed security positions and she desired to purchase them for other clients. Huang obtained bids from broker-dealers through a competitive bidding process to determine the market price for the positions, and Huang arranged with Ge to park them with SGAS generally at the highest bid Huang had received.

22. Huang was motivated to prearrange a buyback of the positions because she believed the bid prices were favorable prices for the securities. Most of the first five sets of positions were repurchased into the Unregistered Fund advised by MSIM.

23. One of the trade sets included sales of two bonds from two separate RIC accounts advised by MSIM that were repurchased into the Unregistered Fund. The Unregistered Fund was an affiliate of the RICs, because the Unregistered Fund was a private fund sponsored and advised by MSIM. By knowingly prearranging purchases by the Unregistered Fund, a RIC affiliate, from the RICs, Huang caused the Unregistered Fund to engage in cross trades prohibited by Section 17(a)(2) of the Investment Company Act, without having obtained an exemptive order or being able to rely on an exemptive rule.

24. Section 17(a)(2) of the Investment Company Act did not apply to the transactions other than the two sales stated in paragraph 23. However, none of the transaction sets complied with MSIM's policies, which applied the requirements of Rule 17a-7 under Section 17 of the Investment Company Act for all cross trades regardless of whether a RIC was involved, because (i) they were crossed at the bid price, not the independent current market price or midpoint between bid and ask, and because (ii) they were conducted through a broker-dealer who received remuneration in connection with the transactions. By prearranging a sale and repurchase at predetermined price levels, Huang avoided paying the full bid/offer spread. However, by crossing securities at the bid price rather than at an average between the bid and the ask, Huang favored the purchasing clients over the selling clients, depriving clients of their share of the market savings, an amount totaling approximately $387,186.

25. MSIM did not adequately implement compliance systems and controls to identify impermissible cross trading, *i.e.*, that Huang was selling and repurchasing for clients the same bonds, in the same sizes, and at identical markups across positions. These circumstances indicated that the series of trades were not separate and distinct arm's-length sale and repurchase transactions.

### c. March 2012 ERISA-Related Trades

26. In March 2012, when implementing a new trading system, MSIM flagged certain mortgage and asset backed securities previously purchased in certain ERISA accounts that may have been ineligible for a common ERISA trading exemption because the securities were not investment grade. Although MSIM noted that the securities were within client guidelines, the Mortgage Team and MSIM management were concerned that the purchases might be considered trade errors under ERISA, which treatment would require MSIM to compensate clients for any losses. At issue were 29 securities held in five ERISA accounts. Over a period of a few weeks beginning in March 2012, the firm conducted a review of the ERISA issues with input from the legal and compliance departments, and ultimately concluded that there was no ERISA violation.

27. While the review of the ERISA issues in March 2012 was ongoing, Huang's supervisors directed her to sell the bonds out of the ERISA accounts. Huang then arranged for a buyback trade involving the positions, which were sold to SGAS on Friday March 23, and repurchased on Monday March 26, the next business day.

28. Huang knew that many of these positions were carried at a loss, because the day before she sold the positions, Huang asked a member of the Mortgage Team to pull the data comparing their purchase prices and current valuations. That analysis showed that 12 of the positions were currently valued lower than their initial cost, and were thus carried at a loss to those clients.

29. Instead of marketing the bonds widely to a number of broker-dealers, Huang arranged to park them with SGAS at prearranged prices that were the higher of MSIM's initial purchase price or the vendor-provided price. This transaction kept the ERISA accounts from realizing losses, but resulted in a package of bonds that was sold to SGAS for about $600,000 above the current prices for the securities. To compensate SGAS for purchasing the bonds at above-market prices, Huang sold two bonds from the Unregistered Fund that were unrelated to the ERISA issue to SGAS as part of the package at prices well below market. The two Unregistered Fund bonds were valued near par (100) but sold by Huang to SGAS at prices of 70 and 80, for no legitimate business purpose. The total discount on these positions approximately offset the total premium on the other bonds that SGAS purchased at above market prices.

30. On the next business day, all of the positions were repurchased by the Unregistered Fund. Huang repurchased them from SGAS at a small markup over the initial sale price paid by SGAS except for the two positions sold from the Unregistered Fund. The Unregistered Fund purchased those two positions at the same prices at which they were sold (70 and 80), without any markup, resulting in no mark to market impact to the Unregistered Fund with respect to these two bonds. In this manner, the ERISA accounts were able to sell positions at artificially inflated prices, SGAS was made whole and received a small markup on the total package, and the two positions

sold from the Unregistered Fund were placed back into the Unregistered Fund, along with the ERISA-related bonds the Unregistered Fund had purchased at a premium.

31. Based on the difference between the trade prices and vendor prices, the Unregistered Fund purchased securities at prices that were $656,697 above the pricing vendor's mid-market price.

**d. Fabricated Dealer Quotes**

32. MSIM's policies required traders to obtain at least two comparable dealer quotes and document those quotes to evidence best execution. When bonds were bought back from SGAS in the prearranged buyback transactions, competing offers generally were not obtained, so on the repurchase, Huang at times instructed a trader on the Mortgage Team to "make up" or fabricate comparable quotes from two randomly-selected dealers to input into MSIM's systems. For the period beginning at least January through March 2012, the trader on the Mortgage Team fabricated multiple quotes relating to the buyback trades with SGAS and entered them into MSIM's systems.

**e. Red Flags and MSIM's Initial Internal Investigation**

33. Within days after the March 2012 trades, MSIM compliance noticed the repurchase of the ERISA bonds and made several requests to Huang for additional information regarding the trades. MSIM compliance staff noted that some accounts were "crossing using a broker" and that the ERISA-related positions were sold and repurchased at identical markups, and notified MSIM's Chief Compliance Officer that there was a questionable sale and repurchase of the ERISA account positions. MSIM compliance staff later identified a prior pattern of matched sales and repurchases by the Mortgage Team.

34. On the date of the repurchase, MSIM's pricing team sent a form email indicating that some of the positions in Huang's trade with SGAS had traded greater than a 5% margin from the vendor price. The form email was of the sort the pricing team would distribute internally to give notice of pricing variances greater than a set threshold. Another internal form email from the pricing team used to indicate day to day price changes greater than a set threshold noted price changes for some positions, when the changes had resulted from the pricing vendor adjusting its prices in line with the MSIM/SGAS traded prices. Huang then instructed the pricing team to challenge the adjusted vendor prices for some of the bonds, indicating that she did not agree with the prices for trades she had executed.

35. Separately, an employee in MSIM risk management flagged for management that the Mortgage Team had sold two positions at 70 and 80 from the Unregistered Fund which were vendor priced around par (100), and then repurchased them from SGAS at the same prices.

36. MSIM compliance investigated the trades from a best execution standpoint, and asked Huang to provide comparable quotes for the March 23, 2012 sales. In response, Huang sent an email falsely stating that the positions were sold through a "competitive all-or-none" bidding process that SGAS had won by submitting the highest bids.

37. Huang also fabricated a list of bids to cover up her failure to obtain competitive bids pursuant to MSIM's best execution policy. Huang obtained a spreadsheet containing the previously-fabricated bids from MSIM's systems. Huang then added more fabricated bids to the spreadsheet to imply that all dealers had bid on each of the bonds, and provided that spreadsheet to an MSIM employee in risk management involved in the review for delivery of the spreadsheet to MSIM compliance.

38. Morgan Stanley's legal department was then notified of the potential problematic trades and conducted an internal investigation of the trades, including a privileged interview of Huang.

39. According to MSIM management, they relied on the investigation conducted by Morgan Stanley's legal department, which concluded that although the trades were questionable, they were not problematic. As a result, MSIM management reprimanded Huang in person and in writing for not escalating the trades internally. Huang remained in charge of the Mortgage Team and continued to raise hundreds of millions of dollars of investor funds for the Unregistered Fund. MSIM took no further action with respect to Huang's prearranged trades until approximately two years later when in 2014, after the Commission's staff asked MSIM for the voluntary production of policies and procedures concerning the parking of securities, Morgan Stanley re-opened the internal investigation, discovered Huang's misconduct and terminated her employment in May 2014.

## **<u>Violations</u>**

40. As a result of Huang's trades with SGAS described above, MSIM willfully[2] violated Section 17(a)(3) of the Securities Act, which prohibits any person in the offer or sale of securities from engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.[3]

41. As a result of Huang's trades with SGAS described above, MSIM willfully violated Section 206(2) of the Advisers Act, which prohibits an investment adviser from engaging in any transaction, practice, or course of business which operates as a fraud or deceit upon a client or prospective client.[4] Specifically, as a result of Huang's broker-dealer interposed cross transactions with SGAS, MSIM favored certain of its clients and failed to seek to obtain

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2 A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v. SEC*, 205 F. 3d 408, 414 (D.C. Cir. 2000)(quoting *Hughes v. SEC,* 174 F.2d 969, 977 (D.C. Cir. 1949)).

3 A violation of Section 17(a)(3) of the Securities Act does not require scienter, but may rest on a finding of simple negligence. *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *Aaron v. SEC,* 446 U.S. 680, 701-02 (1980)).

4 A violation of Section 206(2) of the Advisers Act does not require scienter, but may rest on a finding of simple negligence. *Steadman*, 967 F.2d at 643 n.5 (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)).

best price and execution for certain of its clients in these cross-trades when it allocated the full market savings obtained in the cross transactions to the purchasing clients in the transactions over the selling clients and when it executed trades at off-market prices involving the Unregistered Fund in March 2012.

42. As a result of the conduct described above, MSIM willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires, among other things, that registered investment advisers adopt and implement written policies and procedures reasonably designed to prevent violations, by the investment adviser and its supervised persons, of the Advisers Act and rules. Specifically, MSIM failed to adopt policies addressing "parking" or unlawful prearranged trading and failed to implement its cross trading policies and best execution procedures, and, as a consequence, Huang executed cross transactions through SGAS in a manner that favored certain of its clients and failed to seek to obtain best execution for certain of its clients.

43. As a result of Huang's sales of two bonds from two RICs to the Unregistered Fund through SGAS as described above, MSIM willfully aided and abetted and caused a violation of Section 17(a)(2) of the Investment Company Act, which makes it unlawful for any affiliated person or promoter of or principal underwriter for a RIC or any affiliated person of such a person, promoter, or principal underwriter, acting as principal, knowingly to purchase from such RIC, or from any company controlled by such RIC, any security or other property (except securities of which the seller is the issuer), unless the transaction complies with the exemptive requirements of Rule 17a-7 under the Investment Company Act, or the adviser obtains an exemptive order under Section 17(b) of the Investment Company Act. MSIM did not seek an exemptive order for the cross transactions effected by MSIM when Huang sold two bonds from two RICs to the Unregistered Fund through SGAS, and these transactions were not exempt from the prohibition under Rule 17a-7 because the trades were not executed at a price equal to the average of the highest current independent bid to purchase that security and the lowest current independent offer to sell that security, and were made through a broker-dealer who received remuneration in connection with the transactions.

44. As a result of the conduct described above, MSIM failed reasonably to supervise Huang within the meaning of Section 203(e)(6) of the Advisers Act, with a view to preventing violations of the securities laws. Specifically, MSIM failed to adopt and implement procedures reasonably designed to detect or prevent Huang from violating Sections 17(a)(1) and 17(a)(3) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-5(a) and (c) thereunder, and from aiding and abetting and causing violations of Sections 206(1) and 206(2) of the Advisers Act.

45. As a result of the conduct described above, Huang willfully violated Sections 17(a)(1) and 17(a)(3) of the Securities Act, and Section 10(b) of the Exchange Act and Rules 10b-5(a) and (c) thereunder, which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities, respectively.

46. As a result of the conduct described above, Huang willfully aided and abetted and caused violations of Sections 206(1) and 206(2) of the Advisers Act, which prohibit fraudulent conduct by an investment adviser.

## MSIM's Remedial Efforts

47. In determining to accept MSIM's Offer, the Commission considered remedial acts promptly undertaken by MSIM and cooperation afforded the Commission staff. In particular, MSIM enhanced its policies, procedures, controls and training, voluntarily retained a compliance consultant, and assisted the Commission's staff in its investigation.

## Undertaking

48. MSIM undertakes to distribute, within 90 days of the date of this Order, a sum-total payment in the amount of $857,534 (the "Distribution Fund") in satisfaction of this proceeding to compensate the pooled investment vehicles and separately managed accounts that were harmed as described in ¶ 49(a) below. The Distribution Fund represents the net amount by which these pooled investment vehicles and separately managed accounts would have benefited had MSIM crossed the bonds at an independent market price in the amount of $774,272, plus reasonable interest thereon in the amount of $83,262.

49. MSIM shall be responsible for administering the distribution of the Distribution Fund. MSIM:

a. has submitted to the Commission staff a plan of allocation that identifies (1) each pooled investment vehicle and separately managed account that will receive a portion of the Distribution Fund ("Eligible Recipient"); (2) the exact amount of that payment as to each Eligible Recipient; and (3) the methodology used to determine the exact amount of that payment as to each Eligible Recipient;

b. within ten (10) days of entry of this Order, shall deposit the full amount of the Distribution Fund into an escrow account acceptable to the Commission staff and in the name of and bearing the Employer Identification Number ("EIN") of the Distribution Fund, and shall provide the Commission staff with evidence of such deposit in a form acceptable to the Commission staff; and

c. within 90 days of the entry of this Order will complete transmission of the Distribution Fund to all Eligible Recipients.

50. The Distribution Fund constitutes a Qualified Settlement Fund ("QSF") under Section 468B(g) of the Internal Revenue Code, 26 U.S.C. Section 468B(g), and related regulations, 26 C.F.R. Sections 1.468B-1 through 1.468B-5. MSIM agrees to be responsible for all tax compliance responsibilities associated with distribution of the Distribution Fund and may retain any professional services necessary. The costs and expenses of any such professional services shall be borne by MSIM and shall not be paid out of the Distribution Fund.

51. Within 120 days after the date of the entry of the Order, MSIM shall submit to the Commission staff a final accounting and certification of the disposition of the Distribution Fund not unacceptable to the staff, which shall be in a format to be provided by the Commission staff. The final accounting and certification shall include: (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; (vi) any amounts not distributed to be forwarded to the Commission for transfer to the United States Treasury; and (vii) an affirmation that the amount paid to the clients represents a fair calculation of the Distribution Fund. MSIM shall submit proof and supporting documentation of such payments in a form acceptable to Commission staff. Any and all supporting documentation for the accounting and certification shall be provided to the Commission staff upon request. After MSIM 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 undistributed amount to the United States Treasury.

52. The Commission staff may extend any of the procedural dates for good cause shown. Deadlines for 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.

53. Respondent shall certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to Panayiota K. Bougiamas, Assistant Regional Director, Asset Management Unit, New York Regional Office, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, New York, 10281, no later than sixty (60) days from the date of the completion of the undertakings. In determining whether to accept the Offer, the Commission has considered these undertakings.

## IV.

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

Accordingly, pursuant to Section 8A of the Securities Act, Sections 203(e) and 203(k) of Advisers Act, and Sections 9(b) and 9(f) of the Investment Company Act with respect to MSIM, and pursuant to Section 8A of the Securities Act, Section 21C of the Exchange Act, Sections 203(f) and 203(k) of the Advisers Act and Section 9(b) of the Investment Company Act with respect to Huang, it is hereby ORDERED that:

A. Respondent MSIM cease and desist from committing or causing any violations and any future violations of Section 17(a)(3) of the Securities Act, Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder, and Section 17(a)(2) of the Investment Company Act

B. Respondent Huang cease and desist from committing or causing any violations and any future violations of Sections 17(a)(1) and (3) of the Securities Act, Section 10(b) of the

Exchange Act and Rules 10b-5(a) and (c) thereunder, and Sections 206(1) and 206(2) of the Advisers Act

C. Respondent MSIM is censured.

D. Respondent Huang 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

prohibited from serving or acting as an employee, officer, director, member of an advisory board, investment adviser or depositor of, or principal underwriter for, a registered investment company or affiliated person of such investment adviser, depositor, or principal underwriter;

with the right to apply for reentry after five (5) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

E. Any reapplication for association by Respondent Huang 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 arbitration award related to the conduct that served as the basis for the Commission order; (b) 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 (c) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

F. Within ten (10) days of the entry of this Order, Respondent MSIM shall pay a civil money penalty in the amount of $8,000,000 and Respondent Huang shall pay a civil money penalty of $125,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with the Exchange Act Section 21F(g)(3). 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) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) Respondents 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) Respondents 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 MSIM as the 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 Marshall Sprung, Co-Chief Asset Management Unit, Division of Enforcement, Los Angeles Regional Office, Securities and Exchange Commission, 444 South Flower Street, Suite 900, Los Angeles, CA 90071.

G. 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, Respondents agree that in any Related Investor Action, Respondent 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, Respondents agree that Respondent 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 Securities and Exchange Commission. 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 one or more Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

**V.**

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Huang, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Huang under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Huang of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
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. 9999 / December 22, 2015**

**SECURITIES EXCHANGE ACT OF 1934**
**Release No. 76730 / December 22, 2015**

**INVESTMENT COMPANY ACT OF 1940**
**Release No. 31948 / December 22, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17017**

| In the Matter of<br><br>SG AMERICAS SECURITIES LLC<br>and<br>YIMIN GE<br><br>Respondents. | 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 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 Sections 15(b)(4) and 21C of the Securities Exchange Act of 1934 ("Exchange Act") against SG Americas Securities LLC ("SGAS"), and pursuant to Section 8A of the Securities Act of 1933 ("Securities Act"), Sections 15(b)(6) and 21C of the Exchange Act, and Section 9(b) of the Investment Company Act of 1940 ("Investment Company Act") against Yimin Ge ("Ge") (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, 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, and except as provided herein in Section V, Respondents 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) 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 Respondents' Offers, the Commission finds[1] that:

**Summary**

1. From October 2011 to June 2013, Ge, then a trader at SGAS, a registered broker-dealer, engaged in a series of unlawful prearranged purchases of fixed-income securities and sales back to two different registered investment advisers, Morgan Stanley Investment Management Inc. ("MSIM") and "Firm A".

2. From December 2011 through March 2012, Ge agreed on six separate occasions to buy and then resell bonds with Sheila Huang ("Huang"),[2] a portfolio manager/trader employed by MSIM. The arrangement was that SGAS would temporarily hold or "park" the bonds before reselling them back to MSIM. Ge agreed to purchase the bonds at prices proposed by Huang, with the agreement and understanding that MSIM would repurchase the positions at slight markups within a few days, thus insulating SGAS from market risk. In accordance with this understanding, instead of offering the bonds to the market, Ge reoffered the bonds back to MSIM at a price slightly above the initial purchase price paid by SGAS.

3. As a result, Ge willfully aided and abetted and caused Huang's violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and Rules 10b-5(a) and (c) thereunder.

4. From October 2011 through June 2013, Ge agreed on 14 occasions to similar unlawful prearranged trades at the request of a trader at Firm A, a different registered investment adviser.

5. Because each relevant purchase from MSIM and Firm A was recorded in SGAS's books and records without any reference to the resale or reoffer arrangement, SGAS's books and records were inaccurate. Accordingly, SGAS willfully violated and Ge willfully aided and abetted and caused SGAS's violations of Section 17(a) of the Exchange Act and Rule 17a-3(a)(2) thereunder. Furthermore, SGAS failed reasonably to supervise Ge within the meaning of Section

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

[2] MSIM and Huang are named as respondents in separate administrative and cease-and-desist proceedings relating to their conduct described in this Order.

15(b)(4)(E) of the Exchange Act by failing to prevent and detect Ge's violations with respect to the unlawful parking arrangement with Huang.

## Respondents

6. **SG Americas Securities, LLC** is a broker-dealer registered with the Commission and is headquartered in New York, New York. It is 100% owned by SG Americas Securities Holdings, LLC, which is a wholly owned subsidiary of Societe Generale, a foreign bank headquartered in Paris, France.

7. **Yimin Ge** is 36 years old and resides in New York. She was a senior trader on SGAS's Non-Agency Mortgage Desk from April 2011 to mid-2014. She was terminated by SGAS in June 2014. In October 2014, Ge, without admitting or denying any of its findings, consented to a permanent bar from associating with any Financial Industry Regulatory Authority ("FINRA") member, based on findings that she engaged in unlawful prearranged trading in violation of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder and FINRA rules.

## Facts

8. Each of the 20 relevant sets of trades involved a package of bonds which were sold to SGAS by registered investment advisers (MSIM and Firm A) and then sold back to the respective counterparty within a few days, at a small markup. There was no arm's length negotiation of the price in any of these transactions with respect to the repurchase. Almost all of the positions were non-agency collateralized mortgage obligations ("CMOs"). Ge expected that the traders at MSIM and Firm A would follow through and repurchase the bonds within a few days at a slight markup. The understanding was that the bonds would be temporarily parked with SGAS, and that SGAS would be made whole when MSIM and Firm A repurchased the bonds at a slight markup.

9. From Ge's perspective, these buyback trades were not executed to generate profits for the trading desk. Instead, they were done as a courtesy, at the request of the customer, in order to build and maintain the relationship with important buy-side customers. Ge and the traders at MSIM and Firm A agreed to a small markup across all positions reoffered, regardless of the individual characteristics or sizes of the positions. The small markup was primarily determined by the dollar amount required to cover SGAS's ticketing costs.

### a. SGAS Trades with MSIM

10. From late 2011 through early 2012, Ge and MSIM engaged in a series of six sets of improper prearranged trades of fixed-income securities, primarily CMOs, initiated by Huang, a portfolio manager/trader employed by MSIM.

11. Each set of MSIM/SGAS trades involved a package of bonds which were sold to SGAS and then repurchased by MSIM the next business day, at a small markup on SGAS's purchase price.

12. For each set of relevant trades with MSIM, Ge recklessly disregarded that she was facilitating Huang's improper parking of bonds with SGAS. Ge understood that MSIM would repurchase the bonds at predetermined prices that were based on the initial sale price plus a small markup, without any arm's length negotiation. Ge conducted a very limited review of the positions, because of her understanding that MSIM would repurchase the bonds, and she never offered the relevant positions to any other potential customers prior to reselling them to MSIM. Ge did not seek an explanation as to why MSIM proposed to sell and repurchase securities at no apparent economic benefit to MSIM, thus insulating SGAS from market risk.

13. Ge facilitated the first set of trades on December 1-2, 2011 and agreed to four additional sets of trades with Huang during January and February 2012. Although SGAS had policies prohibiting parking and prearranged trades, SGAS failed to reasonably implement its policies to provide for meaningful follow-up to respond to the potential unlawful prearrangement or parking risks associated with these trades.

14. While the main benefit from the sets of six trades to Ge and SGAS was to accommodate MSIM, SGAS made approximately $183,589 in bid-offer spread from these trades with MSIM.

**b. <u>March 2012 Trades with MSIM</u>**

15. The sixth set of trades, in March 2012, involved numerous positions that were traded between Huang and Ge at off-market prices. They agreed that SGAS would purchase 29 bonds at prices Huang proposed that were, in sum, approximately $600,000 higher than the price of those positions, according to the pricing service used by both SGAS and MSIM. To compensate SGAS for purchasing a package of bonds at above-market prices, Huang also sold two bonds at prices of 70 and 80, respectively, when the pricing service used by SGAS and MSIM marked those bonds near par (100). The total discount on the positions sold at 70 and 80 approximately offset the total premium on the other 29 bonds that were sold above market prices.

16. Because Ge could see that the vendor priced the bonds at materially different prices, and because she had previously traded many of the positions with Huang at prices that were much closer to the vendor prices, she recklessly disregarded whether she was facilitating unlawful prearranged trades at off-market prices. Ge did not seek any explanation as to why Huang proposed these trades at off-market prices.

17. Ge resold all of the positions back to MSIM at a small markup over the initial sale price except for the two positions traded at below-market prices. Those two positions were repurchased at the same prices at which they were sold (70 and 80), without any markup.

**c. <u>SGAS Trades with Firm A</u>**

18. From October 2011 through June 2013, Ge also engaged in a series of 14 similar prearranged trades at pre-set prices with Firm A, another registered investment adviser, without any arm's length negotiation with respect to the repurchase. These buyback trades were similar to the MSIM trades, although the dollar amounts were considerably smaller. For these sets of trades, Ge and the trader at Firm A had an understanding that SGAS would hold the positions for a few

days and then would resell to Firm A, at a slight markup. Ge conducted a very limited review of the positions and she did not offer them to any other customers, because she understood that Firm A would repurchase them. Ge did not seek an explanation as to why Firm A proposed to sell and repurchase securities at no apparent economic benefit to Firm A, thus insulating SGAS from market risk.

19. Ge understood that when the trader at Firm A offered positions at a set price and noted something such as, "I will have buy interest" or "these are core positions" or "we like these credits," the trader was proposing a buyback trade in which he would repurchase the bonds at a slight markup shortly thereafter.

20. The sets of trades with Firm A involved approximately 60 different positions, all of which were reoffered and repurchased at small markups. SGAS made approximately $14,749 in bid-offer spread from this series of trades with Firm A.

**d. <u>SGAS Policies and Procedures</u>**

21. SGAS's written policies prohibited employees from participating in or facilitating parking of securities, and prohibited prearranged trades, which the policies defined as "trades involving an offer to sell (buy) a security coupled with an offer to buy (sell) back that security at the same or better price without any bona fide trading purpose." These policies also required accurate trade entry: "any sale or purchase of a security that includes an agreement to repurchase or resell the security . . . must be completely documented and recorded in the appropriate trade entry systems at the time of the initial transaction."

22. SGAS failed to reasonably implement its policies with respect to parking and prearranged trades in order to prevent and detect the improper prearranged trades executed by Ge. For example, SGAS did not have any process in place to identify or review back-and-forth trades with customers within a short period of time to identify potential unlawful prearrangement or parking.

**e. <u>Buyback Trades Were Incorrectly Recorded on SGAS's Books and Records</u>**

23. When Ge entered the relevant purchases from MSIM or Firm A into SGAS's internal systems or instructed SGAS sales staff to enter the trades, she omitted mention of the agreement to resell the securities. Instead, the first leg was recorded as a purchase in the firm's books and records. Ge's understanding of these trades – that SGAS was insulated from the risks of ownership because MSIM or Firm A would repurchase the bonds at predetermined prices – was not reflected in SGAS's books and records, which were therefore inaccurate.

24. Ge was responsible for accurate reporting on SGAS's books and records, but she did not accurately record her understanding that MSIM and Firm A would repurchase the bonds sold to SGAS.

## Violations

25. As a result of the conduct described above, SGAS willfully[3] violated Section 17(a) of the Exchange Act and Rule 17a-3(a)(2) thereunder, which require that each registered broker-dealer make and keep current ledgers (or other records) reflecting all assets and liabilities, income, and expense and capital accounts relating to the broker-dealer's business. As a result of the conduct described above, SGAS's ledgers did not accurately reflect the understandings reached between SGAS and its counterparties that those counterparties would repurchase the bonds sold to SGAS.

26. As a result of the conduct described above, SGAS failed reasonably to supervise Ge while she was a registered representative associated with SGAS within the meaning of Section 15(b)(4)(E) of the Exchange Act with a view to preventing and detecting her aiding and abetting violations of the federal securities laws.

27. As a result of the conduct described above, Ge willfully aided and abetted and caused Huang's violations of Sections 17(a)(1) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and Rules 10b-5(a) and (c) thereunder, which prohibit fraudulent conduct in the offer or sale of securities and in connection with the purchase or sale of securities, respectively.

28. As a result of the conduct described above, Ge willfully aided and abetted and caused SGAS's violations of Section 17(a) of the Exchange Act and Rule 17a-3(a)(2) thereunder, which require that each registered broker-dealer make and keep current ledgers (or other records) reflecting all assets and liabilities, income, and expense and capital accounts relating to the broker-dealer's business.

## SGAS's Remedial Efforts and Cooperation

29. In determining to accept SGAS's Offer, the Commission considered remedial acts promptly undertaken by SGAS and cooperation afforded the Commission staff.

## Ge's Cooperation

30. In determining to accept Ge's Offer, the Commission considered Ge's cooperation with the Commission staff in its investigation.

## IV.

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

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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)).

Accordingly, pursuant to Sections 15(b)(4) and 21C of the Exchange Act with respect to SGAS, and pursuant to Section 8A of the Securities Act, Sections 15(b)(6) and 21C of the Exchange Act, and Section 9(b) of the Investment Company Act with respect to Ge, it is hereby ORDERED that:

A. Respondent SGAS cease and desist from committing or causing any violations and any future violations of Section 17(a) of the Exchange Act and Rule 17a-3(a)(2) thereunder.

B. Respondent Ge cease and desist from committing or causing any violations and any future violations of Sections 17(a)(1) and (3) of the Securities Act, Section 10(b) of the Exchange Act and Rules 10b-5(a) and (c) thereunder, and Section 17(a) of the Exchange Act and Rule 17a-3(a)(2) thereunder.

C. Respondent SGAS is censured.

D. Respondent Ge 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
>
> 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; 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.

with the right to apply for reentry after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

E. Any reapplication for association by Respondent Ge 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 arbitration award related to the conduct that served as the basis for the Commission order; (b) 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 (c) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

F. Respondent SGAS shall, within ten (10) calendar days of the entry of this Order, pay disgorgement, representing profits gained as a result of the conduct described herein of $198,338 and prejudgment interest of $12,755 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with Exchange Act Section 21F(g)(3). The disgorgement amount represents the amount of essentially riskless profits that SGAS received for facilitating the buyback trades. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600. 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 SGAS as the 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 Panayiota K. Bougiamas, Assistant Regional Director, Asset Management Unit, New York Regional Office, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, New York, 10281.

G. Respondent SGAS shall, within ten (10) calendar days of the entry of this Order, pay a civil money penalty in the amount of $800,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with the Exchange Act Section 21F(g)(3). Respondent Ge shall pay a civil money penalty of $25,000 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury in accordance with the Exchange Act Section 21F(g)(3) in two installments, with Payment 1 in the amount of $12,500 due within ten (10) calendar days of the entry of this Order, and Payment 2 in the amount of $12,500 due within 180 calendar days of the entry of this Order. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. If any payment by Respondent Ge is not made by the date the payment is required by this Order, the entire outstanding balance of Ge's civil penalty, plus any additional interest accrued pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways: (1) Respondents may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) Respondents 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) Respondents 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 either SGAS or Ge as the 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 Panayiota K. Bougiamas, Assistant Regional Director, Asset Management Unit, New York Regional Office, Securities and Exchange Commission, Brookfield Place, 200 Vesey Street, Suite 400, New York, New York, 10281.

H. Respondent Ge acknowledges that the Commission is not imposing a civil penalty in excess of $25,000 based upon her cooperation in a Commission investigation. If at any time following the entry of the Order, the Division of Enforcement ("Division") obtains information indicating that Respondent knowingly provided materially false or misleading information or materials to the Commission or in a related proceeding, the Division may, at its sole discretion and with prior notice to the Respondent, petition the Commission to reopen this matter and seek an order directing that the Respondent pay an additional civil penalty. Respondent may contest by way of defense in any resulting administrative proceeding whether it knowingly provided materially false or misleading information, but may not: (1) contest the findings in the Order; or (2) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

I. 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, Respondents agree that in any Related Investor Action, Respondent 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, Respondents agree that Respondent 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 Securities and Exchange Commission. 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 one or more Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

## V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Ge, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Ge under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Ge of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
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. 76740 / December 22, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17020**

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| **In the Matter of**<br><br>**DIANE D. DALMY, Esq.**<br><br>**Respondent.** | **ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS AND IMPOSING TEMPORARY SUSPENSION PURSUANT TO RULE 102(e)(3)(i)(B) OF THE COMMISSION'S RULES OF PRACTICE** |

**I.**

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted against Diane D. Dalmy ("Respondent" or "Dalmy") pursuant to Rule 102(e)(3)(i)(B)[1] of the Commission's Rules of Practice (17 C.F.R. § 200.102(e)(3)(i)(B)).

**II.**

The Commission finds that:

1. Diane D. Dalmy is an attorney licensed in the State of Colorado.

2. In 2009, Dalmy served as transaction counsel for Zenergy International, Inc.'s reverse merger with Paradigm Tactical Products, Inc. In addition to advising on the structure of

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

> The Commission, with due regard to the public interest and without preliminary hearing, may, by order, temporarily suspend from appearing or practicing before it any attorney . . . who has been by name: (B) [f]ound by any court of competent jurisdiction in an action brought by the Commission to which he or she is a party . . . to have violated (unless the violation was found not to have been willful) or aided and abetted the violation of any provision of the Federal securities laws or of the rules and regulations thereunder.

the transaction and drafting the documents needed to implement it, she drafted and submitted attorney opinion letters to Zenergy's transfer agent stating that Zenergy's shares were exempt from registration and approving the issuance of unrestricted stock. Holders of the purportedly unrestricted stock obtained at least $4.4 million from their stock sales to public investors, and Dalmy personally sold 1 million shares to public investors for $43,995.

3. On August 1, 2013, the Commission filed a complaint against Dalmy alleging that she violated Sections 5(a) and 5(c) of the Securities Act of 1933 ("Securities Act"). The complaint sought a permanent statutory-based injunction; a conduct-based injunction from participating in the issue, offer, or sale of penny stocks; disgorgement plus prejudgment interest; and civil monetary penalties. *SEC v. Zenergy Int'l, Inc.*, N.D. Ill. Case No. 13-cv-05511.

4. On September 30, 2015, the United States District Court for the Northern District of Illinois granted the Commission's motion for partial summary judgment on its claims against Dalmy. The court found that there was no genuine dispute of material fact that Dalmy violated Section 5 of the Securities Act based on the undisputed factual showing that Dalmy sold Zenergy shares, those shares were unregistered, and no exemption to the registration requirements applied. The court did not find that Dalmy's violations were not willful. The court did not address the Commission's requests for injunctive and monetary relief in its order.

**III.**

Based on the foregoing, the Commission finds that Dalmy has been found by a court of competent jurisdiction, in an action brought by the Commission, to have violated provisions of the federal securities laws, within the meaning of Rule 102(e)(3)(i)(B) of the Commission's Rules of Practice. In view of this finding, the Commission deems it appropriate and in the public interest that Dalmy be temporarily suspended from appearing or practicing before the Commission as an attorney. Accordingly,

IT IS HEREBY ORDERED that Dalmy be, and hereby is, temporarily suspended from appearing or practicing before the Commission as an attorney. This Order will be effective upon service on the Respondent.

IT IS FURTHER ORDERED that Dalmy may, within thirty days after service of this Order, file a petition with the Commission to lift the temporary suspension. If the Commission receives no petition within thirty days after service of the Order, the suspension will become permanent pursuant to Rule 102(e)(3)(ii).

If a petition is received within thirty days after service of this Order, the Commission will, within thirty days after the filing of the petition, either lift the temporary suspension, or schedule the matter for hearing at a time and place to be designated by the Commission, or both. If a hearing is ordered, following the hearing, the Commission may lift the suspension, censure the petitioner, or disqualify the petitioner from appearing or practicing before the Commission for a period of time, or permanently, pursuant to Rule 102(e)(3)(iii).

This Order shall be served upon Dalmy personally or by certified mail at her last known address.

By the Commission.

Brent J. Fields
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. 76741 / December 22, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17021**

**In the Matter of**

**DANNY E. CARPENTER,**
**ALWYN T. WYCHE, JR.,**
**PHILIP HOLLEY, and**
**WAYNE K. SOUD, JR.,**

**Respondents.**

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

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate that cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 21C of the Securities Exchange Act of 1934 ("Exchange Act"), against Danny E. Carpenter ("Carpenter"), Alwyn T. Wyche, Jr. ("Wyche"), Philip Holley ("Holley"), and Wayne K. Soud, Jr. ("Soud") (collectively, "Respondents").

## II.

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

III.

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

**Summary**

1. This matter involves the tipping of inside information by Respondent Carpenter, then the Chief Financial Officer of Acadia, and insider trading by Respondents Wyche, Holley, and Soud in the securities of Pioneer Behavioral Health, Inc. ("PHC") in advance of the May 24, 2011 announcement that Acadia Healthcare Company, Inc. ("Acadia") had agreed to acquire PHC.

2. Between December 2010 and January 2011, as CFO of Acadia, Carpenter learned that Acadia was considering an acquisition of PHC. Carpenter knew that he had a fiduciary duty to maintain this information in confidence.

3. On or around January 21, 2011, Carpenter informed Holley that Acadia was considering a transaction with PHC. Shortly thereafter, Holley informed Soud of what Carpenter had told him, with the recognition that Soud might trade. Both Holley and Soud purchased PHC shares while in possession of this material nonpublic information. Both Holley and Soud knew that Carpenter had learned this information through his position as a senior executive at Acadia. Both Holley and Soud knew or should have known that Carpenter disclosed this information in breach of a fiduciary duty owed to Acadia.

4. Holley also recommended PHC as a potential investment to another person with whom he had a close relationship ("Individual A"). Following and as a result of that discussion, Individual A did purchase shares of PHC. As a result of his improper use of the insider information, Holley and Individual A generated gains of $8,120.

5. As a result of his improper use of the insider information, Soud generated gains of $13,710.

6. In or around late March or early April 2011, Carpenter told Wyche that Acadia would be making a significant acquisition. As a result of this conversation, Wyche purchased shares of PHC based on this material nonpublic information. Wyche knew that Carpenter had learned this information through his position as a senior executive at Acadia. Wyche knew or should have known that Carpenter disclosed this information in breach of a fiduciary duty owed to Acadia. As a result of this improper use of insider information, Wyche generated gains of approximately $34,022.

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

7. As a result of the conduct described above, Respondents violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

**Respondent**

8. *Danny E. Carpenter*, age 56, resides in Florida. During the relevant time, Carpenter was Chief Financial Officer, and then divisional CFO, of Acadia, and resided in Georgia.

9. *Alwyn T. Wyche, Jr.*, age 69, resides in Georgia. During the relevant time, Wyche resided in Georgia. Wyche owns a home appliance business.

10. *Philip Holley* resides in Georgia. During the relevant time, Holley provided professional and consultative services to Acadia, and resided in Georgia.

11. *Wayne K. Soud, Jr.*, age 46, resides in Georgia. During the relevant time, Soud provided professional and consultative services to Acadia, and resided in Georgia.

**Other Relevant Persons**

12. *Pioneer Behavioral Health, Inc.* was a Massachusetts company headquartered in Peabody, MA. It provided behavioral health services. Its common stock was registered with the Commission pursuant to Section 12(b) of the Exchange Act until after it was acquired by Acadia. PHC's common stock traded on the American Stock Exchange (former ticker symbol PHC).

13. *Acadia Healthcare Company, Inc.* is an SEC reporting company incorporated in Delaware and headquartered in Franklin, TN. It provides behavioral health services. Its common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act. Acadia's common stock is traded on NASDAQ Global Market under the ticker symbol ACHC.

14. *Individual A* was a person known by Holley, with whom Holley had a close relationship. Individual A resided in Georgia during the relevant time period.

**Facts**

15. From 2008 through 2013, Carpenter worked at Acadia, initially as Chief Financial Officer and later as Divisional CFO. Between December 2010 and January 2011, as CFO of Acadia, Carpenter learned that Acadia would be pursuing an acquisition of PHC. Carpenter participated in due diligence for the acquisition of PHC. Carpenter knew that the information about the acquisition was material and nonpublic, and that he had an obligation to maintain the confidentiality of the information. Carpenter gave that market-sensitive information to his good friends, Wyche and Holley, in breach of a fiduciary duty owed to Acadia. Carpenter knew or was reckless in not knowing that Wyche and Holley might trade based on that information.

16. Wyche and Holley knew at the time that Carpenter was a senior executive at Acadia. Wyche and Holley knew that Carpenter received the information he conveyed about the

potential transaction through his position as a senior executive at Acadia. Wyche and Holley knew that the information about the potential transaction was not public, and knew or should have known that the information was disclosed by Carpenter in breach of a duty.

17. Within a few days of his conversation with Carpenter, Holley told Soud that he had learned from Carpenter that Acadia was considering a transaction with PHC. Holley shared this information with Soud with the recognition that Soud might trade based on it. Shortly after the conversation between Holley and Soud, Holley also sent Soud an email, telling Soud how many shares of PHC Holley had purchased.

18. Like Holley, Soud knew that Carpenter was CFO of Acadia. Soud knew that Carpenter had received the information about the transaction with PHC through his position as a senior executive at Acadia. Soud knew that the potential transaction was not public, and knew or should have known that the information was disclosed by Carpenter in breach of a duty.

19. Following his conversation with Carpenter about the transaction between PHC and Acadia, Holley recommended PHC as a potential investment to Individual A, a person with whom he had a close relationship.

20. On February 14, 2011, after learning of the potential transaction, Holley purchased 4,500 shares of PHC across two separate accounts that he controlled. Holley purchased these shares while in possession of material nonpublic information about the potential transaction with PHC that Carpenter had communicated to him. Prior to February 14, 2011, Holley had never purchased PHC shares.

21. On February 24, 2011, based on his discussion with Holley, Individual A purchased 2,000 shares across two separate accounts that he controlled. Prior to February 24, 2011, Individual A had never purchased PHC shares.

22. On February 8, February 18, and April 14, 2011, after learning of the potential transaction, Soud purchased 14,742 shares of PHC. Soud purchased these shares while in possession of the material nonpublic information about the potential transaction with PHC that Carpenter had communicated to Holley, and Holley communicated to Soud. Prior to February 8, 2011, Soud had never purchased PHC shares. On May 9, 2011, Soud sold 3,874 of these shares.

23. Between April 4 and May 18, 2011, after learning of the potential transaction, Wyche purchased 37,000 shares of PHC across three separate accounts that he controlled. Wyche purchased these shares while in possession of the material nonpublic information about the transaction with PHC that Carpenter had communicated to him. Prior to April 4, 2011, Wyche had never purchased PHC shares.

24. On May 23, 2011, PHC and Acadia executed the merger agreement. At 8:45 a.m. on May 24, 2011, PHC and Acadia issued joint press releases announcing that the companies had entered into a definitive merger agreement.

25. The market reacted positively to the news. The closing last sale price of PHC on the day of the announcement was $3.61, an increase of approximately 20% over the prior day's

close. Trading volume on the day of the announcement was 1.8 million shares, compared to PHC's historical average daily volume of approximately 56,700 shares.

26. As of the close of market on May 24, 2011, the PHC shares purchased by Holley on February 14, 2011 had increased in value by $5,220.

27. As of the close of market on May 24, 2011, the PHC shares purchased by Individual A on February 24, 2011 had increased in value by $2,900.

28. As of the close of market on May 24, 2011, the PHC shares purchased by Soud in February and April 2011, less those sold on May 9, had increased in value by $13,710.

29. As of the close of market on May 24, 2011, the PHC shares purchased by Wyche in April and May 2011 had increased in value by $34,022.

30. As a result of the conduct described above, Respondents violated Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

**Cooperation by Respondents Wyche and Holley**

In determining to accept the Offers of Respondents Wyche and Holley, the Commission considered the cooperation each has afforded the Commission staff, including the following undertakings.

**Undertakings**

31. In connection with this action and any related judicial or administrative proceeding or investigation commenced by the Commission or to which the Commission is a party, Respondents Holley and Wyche (i) agree to appear and be interviewed by the 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) with respect to such notices and subpoenas, waive 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 Respondents' travel, lodging, and subsistence expenses at the then-prevailing U.S. Government per diem rates; and (iv) consent to personal jurisdiction over Respondents in any United States District Court for purposes of enforcing any such subpoena.

**IV.**

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondents' Offers.

Accordingly, it is hereby ORDERED that:

A. Pursuant to Section 21C of the Exchange Act, Respondents cease and desist from committing or causing any violations and any future violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

B. Respondent Carpenter shall, within 10 days of the entry of this Order, pay a civil money penalty in the amount of $39,242 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). 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 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 Danny E. Carpenter 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 Scott Friestad, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010.

C. Respondent Holley shall, within 10 days of the entry of this Order, pay disgorgement of $8,120, which represents profits gained by Holley and by Individual A as a result of the conduct described herein; prejudgment interest of $1,193; and a civil money penalty in the amount of $4,060 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment of disgorgement and prejudgment interest is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and if timely payment of the civil money penalty is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the ways described in Section IV.B. Payments by check or money order must be accompanied by a cover letter identifying Philip Holley 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 Scott Friestad, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010.

D. Respondent Holley acknowledges that the Commission is not imposing a civil penalty in excess of $4,060 based upon his cooperation and agreement to cooperate in a Commission investigation and/or related enforcement action. If at any time following the entry of the Order, the Division of Enforcement obtains information indicating that Respondent Holley knowingly provided materially false or misleading information or materials to the Commission, or in a related proceeding, the Division may, at its sole discretion and with prior notice to Respondent Holley, petition the Commission to reopen this matter and seek an order directing that Respondent Holley pay an additional civil penalty. Respondent Holley may contest by way of defense in any resulting administrative proceeding whether he knowingly provided materially false or misleading information, but may not: (1) contest the findings in the Order; or (2) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

E. Respondent Soud shall, within 10 days of the entry of this Order, pay disgorgement of $13,710, which represents profits gained as a result of the conduct described herein; prejudgment interest of $2,014; and a civil money penalty in the amount of $13,710 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). If timely payment of disgorgement and prejudgment interest is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and if timely payment of the civil money penalty is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717. Payment must be made in one of the ways described in Section IV.B. Payments by check or money order must be accompanied by a cover letter identifying Wayne K. Soud, Jr. 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 Scott Friestad, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010.

F. Respondent Wyche shall pay disgorgement of $7,116; prejudgment interest of $993; and a civil money penalty in the amount of $7,116 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Exchange Act Section 21F(g)(3). Payment shall be made in the following installments: $3,806.25 within 10 days of the entry of this Order; $3,806.25 within three months following the entry of this Order; $3,806.25 within six months following the entry of this Order; and $3,806.25 within nine months following the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of disgorgement, prejudgment interest, and civil penalties, plus any additional interest accrued pursuant to SEC Rule of Practice 600 and/or 31 U.S.C. § 3717 shall be due and payable immediately, without further application. Payment must be made in one of the ways described in Section IV.B. Payments by check or money order must be accompanied by a cover letter identifying Alwyn T. Wyche, Jr. 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 Scott Friestad, Division of Enforcement, Securities and Exchange Commission, 100 F St., NE, Washington, DC 20549-5010.

G. Respondent Wyche acknowledges that the Commission is not imposing disgorgement greater than $7,116, nor a civil penalty in excess of $7,116, based upon his cooperation and agreement to cooperate in a Commission investigation and/or related enforcement action. If at any time following the entry of the Order, the Division of Enforcement obtains information indicating that Respondent Wyche knowingly provided materially false or misleading information or materials to the Commission, or in a related proceeding, the Division may, at its sole discretion and with prior notice to Respondent Wyche, petition the Commission to reopen this matter and seek an order directing that Respondent Wyche pay an additional civil penalty. Respondent Wyche may contest by way of defense in any resulting administrative proceeding whether he knowingly provided materially false or misleading information, but may not: (1) contest the findings in the Order; or (2) assert any defense to liability or remedy, including, but not limited to, any statute of limitations defense.

H. 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, Respondents agree that in any Related Investor Action, they shall not argue that they are entitled to, nor shall they benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondents' payments of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondents agree that they 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 Securities and Exchange Commission. 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, "Related Investor Action" means a private damages action brought against any of the Respondents by or on behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. §523, the findings in this Order are true and admitted by Respondents, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondents under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondents of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. §523(a)(19).

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 4300 / December 22, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17022**

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| **In the Matter of**<br><br>**DAVID A. BRYSON**<br><br>**Respondent.** | **ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940** |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against David A. Bryson ("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 admits the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Sections III.3. and III.4. below, and consents to the entry of this Order Instituting Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Order"), as set forth below.

## III.

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

1. Respondent, age 47, resided in Ridgefield, Connecticut during the relevant period. During the period of the conduct described below, Respondent was an owner, managing

partner and a founder of New Stream Capital, LLC ("New Stream"), an unregistered investment adviser in Ridgefield, Connecticut that at one time managed a $750-plus million hedge fund focused on illiquid investments in asset-based lending. Respondent once held Series 3, 7, 63 and 65 licenses.

2. On February 26, 2013, the Commission filed a Complaint ("Complaint") naming Respondent as a defendant in a civil action pending in the United States District Court for the District of Connecticut, SEC v. New Stream Capital, LLC, et al., Civil Action No. 3:13-cv-00264. The Commission's Complaint alleges, inter alia, that Respondent participated in a fraudulent scheme to mislead investors and advisory clients about the capital structure of a hedge fund managed and advised by New Stream.

3. On May 21, 2014, Respondent pled guilty to one count of conspiracy to commit wire fraud in violation of Title 18 United States Code, Section 371 before the United States District Court for the District of Connecticut, in United States v. Bryson, 3:13-cr-41 (JCH). On May 15, 2015, a judgment in the criminal case was entered against Respondent. He was sentenced to, among other things, a prison term of 33 months followed by three years of supervised release.

4. On December 21, 2015, the United States District Court for the District of Connecticut entered, by consent, a final judgment against Respondent permanently enjoining him from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, Section 17(a) of the Securities Act of 1933, and Sections 206(1), (2) and (4) of the Advisers Act and Rule 206(4)-8 thereunder.

## 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 203(f) of the Advisers Act that Respondent be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent.

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.

Brent J. Fields
Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 4301 / December 22, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17023**

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| **In the Matter of**<br><br>**BART C. GUTEKUNST**<br><br>**Respondent.** | **ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940** |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate and in the public interest that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") against Bart C. Gutekunst ("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 admits the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Sections III.3. and III.4. below, and consents to the entry of this Order Instituting Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Order"), as set forth below.

## III.

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

1. Respondent, age 63, resided in Weston, Connecticut during the relevant period. During the period of the conduct described below, Respondent was an owner, managing

partner and a founder of New Stream Capital, LLC ("New Stream"), an unregistered investment adviser in Ridgefield, Connecticut that at one time managed a $750-plus million hedge fund focused on illiquid investments in asset-based lending.

2. On February 26, 2013, the Commission filed a Complaint ("Complaint") naming Respondent as a defendant in a civil action pending in the United States District Court for the District of Connecticut, SEC v. New Stream Capital, LLC, et al., Civil Action No. 3:13-cv-00264. The Commission's Complaint alleges, inter alia, that Respondent participated in a fraudulent scheme to mislead investors and advisory clients about the capital structure of a hedge fund managed and advised by New Stream.

3. On May 21, 2014, Respondent pled guilty to one count of conspiracy to commit wire fraud in violation of Title 18 United States Code, Section 371 before the United States District Court for the District of Connecticut, in United States v. Gutekunst, 3:13-cr-41 (JCH). On May 20, 2015, a judgment in the criminal case was entered against Respondent. He was sentenced to, among other things, a prison term of 30 months followed by three years of supervised release.

4. On December 21, 2015, the United States District Court for the District of Connecticut entered, by consent, a final judgment against Respondent permanently enjoining him from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, Section 17(a) of the Securities Act of 1933, and Sections 206(1), (2) and (4) of the Advisers Act and Rule 206(4)-8 thereunder.

## 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 203(f) of the Advisers Act that Respondent be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent.

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.

Brent J. Fields
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. 76734 / December 22, 2015**

**ACCOUNTING AND AUDITING ENFORCEMENT**
**Release No. 3729 / December 22, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17018**

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| **In the Matter of**<br><br>**SPICER JEFFRIES LLP,**<br><br>**Respondent.** | **ORDER INSTITUTING PUBLIC ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 4C OF THE SECURITIES EXCHANGE ACT OF 1934 AND RULE 102(e) OF THE COMMISSION'S RULES OF PRACTICE, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS** |

## I.

The Securities and Exchange Commission ("Commission") deems it appropriate that public administrative proceedings be, and hereby are, instituted against Spicer Jeffries LLP ("Spicer Jeffries" or "Respondent") pursuant to Section 4C[1] of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.[2]

[1] Section 4C provides, in relevant part, that:

> The Commission may censure any person, or deny, temporarily or permanently, to any person the privilege of appearing or practicing before the Commission in any way, if that person is found . . . (1) not to possess the requisite qualifications to represent others . . . (2) to be lacking in character or integrity, or to have engaged in unethical or improper professional conduct; or (3) to have willfully violated, or willfully aided and abetted the violation of, any provision of the securities laws or the rules and regulations thereunder.

[2] Rule 102(e)(1)(ii) provides, in pertinent part, that:

> The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found . . . to have engaged in unethical or improper professional conduct.

## 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 Public Administrative Proceedings Pursuant to Section 4C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions ("Order"), as set forth below.

## III.

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

### A. SUMMARY

These proceedings arise out of Spicer Jeffries' failure to retain audit documentation, as required by Generally Accepted Auditing Standards ("GAAS"). Spicer Jeffries was unable to locate audit documentation for six (6) of its audit engagements for the years 2009 through 2013. Spicer Jeffries did not have written policies and procedures outlining the practices followed for retention of audit documentation. The affected clients are registered broker-dealers who were required by Section 17(e)(1)(A) of the Exchange Act and Rules 17a-5(d)(1)(i) and 17a-5(g)(1)[3] thereunder to file annual financial reports that are audited by an independent public accountant pursuant to GAAS. GAAS required that audit documentation for such annual audits be retained for a period of at least five years from the report release date.[4] Spicer Jeffries' failure to retain audit documentation

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[3] The provisions of Exchange Act Rule 17a-5 referred to herein are those in effect during, and applicable to, the relevant conduct. On July 30, 2013, the Commission adopted certain amendments to Rule 17a-5. *See* Broker-Dealer Reports, SEC Exchange Act Release No. 34-70073 (July 30, 2013), 78 Fed. Reg. 51910 (Aug. 21, 2013). Among other things, the amendments to Rule 17a-5 require that audits of brokers and dealers be performed in accordance with Public Company Accounting Oversight Board standards, effective for audits of fiscal years ending on or after June 1, 2014.

Prior to the July 30, 2013 amendments, Rule 17a-5 required that audits of brokers or dealers be performed in accordance with auditing standards generally accepted in the United States of America, established by the American Institute of Certified Public Accountants ("AICPA"). *See* SEC Exchange Act Release No. 34-62991 (Sept. 24, 2010), 75 Fed. Reg. 60616 (Oct. 1, 2010) (clarifying that references in Commission rules and staff guidance and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to non-issuer brokers or dealers, should continue to be understood to mean auditing standards generally accepted in the United States of America, established by the AICPA).

[4] *See* AU-C Section 230.17, *Audit Documentation*, (effective for audits of financial statements for periods ending on or after December 15, 2012); AU Section 339.32, *Audit Documentation* (effective for

in accordance with GAAS for six (6) audits for the years 2009 through 2013 of registered broker-dealers constitutes improper professional conduct.

## B. RESPONDENT

**Spicer Jeffries LLP** is an accounting and auditing firm registered with the Public Company Accounting Oversight Board ("PCAOB"). Spicer Jeffries is based in Denver, Colorado and recently opened offices in Florida and the Cayman Islands. During fiscal years 2009 through 2013 (the "Relevant Period"), Spicer Jeffries had two partners and approximately twenty-nine professional staff.

## C. FACTS

### 1. Background

a. During the Relevant Period, Spicer Jeffries issued approximately 350 audit reports for broker-dealers registered with the Commission. For the year ended 2013, Spicer Jeffries completed 74 audits of broker-dealers.

b. During the Relevant Period, broker-dealers were required to annually file with the Commission financial reports audited by an independent public accountant in accordance with GAAS. During the Relevant Period, GAAS required that the independent public accountant retain audit documentation for a period of at least five years from the report release date.

c. Applicable GAAS standards state that an auditor "should adopt reasonable procedures to retain and access audit documentation for a period of time sufficient to meet the needs of his or her practice and to satisfy any applicable legal or regulatory requirements for records retention."[5]

d. Spicer Jeffries was managed by two partners, a majority partner and a minority partner. The majority partner relied solely on the minority partner to ensure compliance with professional standards and other requirements related to audit documentation retention. The minority partner was responsible for overseeing the policies and procedures related to retention of audit documentation, but the policies, procedures, and oversight were inadequate to reasonably assure compliance with GAAS.

e. Spicer Jeffries' written policy regarding audit documentation retention stated that audit documentation was to be retained for a period of six years after the balance sheet date. Spicer

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audits of financial statements for periods ending on or after December 15, 2006 and prior to December 15, 2012). PCAOB standards require a seven-year retention period. *See* PCAOB Auditing Standard No. 3, *Audit Documentation*, paragraph 14.

[5] *See* AU Section 339.32 *Audit Documentation*; AU-C Section 230, Appendix A, paragraph .A27, *Audit Documentation.*

Jeffries' administrative staff followed certain practices to retain audit documentation for this period. The firm did not, however, have written procedures outlining these practices. The firm's management did not regularly review administrative staff's practices to ensure the administrative staff reasonably followed those practices.

f. Spicer Jeffries maintained on-site file storage for audit documentation that was less than one year old. Spicer Jeffries allowed all personnel to access the on-site file storage. The firm maintained a system to record the names and dates of individuals who removed audit documentation and the names and dates such documentation was returned to the on-site file storage. Although the system was in place, the records were not regularly verified, and certain records were incomplete.

g. Spicer Jeffries generally archived audit documentation older than one year at an off-site facility. During the Relevant Period, Spicer Jeffries maintained a master archive list to document the location of archived audit documentation. The master archive list contained inaccuracies during the Relevant Period.

h. At the end of 2013, the minority partner retired from Spicer Jeffries, and the administrative staff continued to carry out the existing audit documentation retention practices. From January 1, 2014 until January 1, 2015, no other partner assumed responsibility of audit documentation retention practices, although the firm's partners were available to the administrative staff if they had questions.

**Failure to Retain Audit Documentation**

i. In response to requests for documents issued by the Commission, Spicer Jeffries was unable to locate audit documentation for six audit engagements of registered broker-dealers during the Relevant Period.[6]

**Remedial Efforts**

j. In 2015, a new partner took over direct responsibility for audit documentation retention. Spicer Jeffries took steps to review and analyze its audit documentation retention practices and developed new written policies and procedures regarding audit documentation retention. Spicer Jeffries will hire an independent consultant at its own expense to evaluate its audit documentation retention policies and procedures.

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6 Spicer Jeffries acknowledged during the investigation that out of 113 audit files for which information was requested, it failed to retain documentation for six of those audit engagements.

2. **Violations**

a. Section 4C of the Exchange Act and Rule 102(e) of the Commission's Rules of Practice allow the Commission to censure a person if it finds that such person has engaged in "improper professional conduct." Exchange Act § 4C(a)(2); Rule 102(e)(1)(ii). Section 4C and Rule 102(e) define improper professional conduct, in part, as "[r]epeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission." Exchange Act § 4C(b)(2)(B); Rule 102(e)(1)(iv)(B)(2). As a result of the conduct described above, Spicer Jeffries engaged in repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards that indicate a lack of competence to practice before the Commission.

3. **Findings**

a. Based on the foregoing, the Commission finds that Spicer Jeffries engaged in improper professional conduct pursuant to Section 4C(a)(2) of the Exchange Act and Rule 102(e)(1)(ii) of the Commission's Rules of Practice.

4. **Remedial Efforts**

In determining whether to accept the Offer, the Commission considered remedial acts undertaken by Respondent.

**Undertakings**

Respondent undertakes to:

1. Retain, within sixty (60) days after the entry of this Order, at its own expense, an independent consultant ("Independent Consultant") not unacceptable to the staff of the Commission, to review and evaluate whether Spicer Jeffries' audit documentation retention policies and procedures are designed and implemented in a manner reasonably sufficient under PCAOB standards and applicable Commission rules to retain all audit documentation in accordance with applicable professional standards. Spicer Jeffries shall cooperate fully with the Independent Consultant and shall provide the Independent Consultant with access to its own files, books, records, and personnel as reasonably requested for the review;

2. Require that the Independent Consultant issue a report, within sixty (60) days of being retained, summarizing the review and recommending additional or revised audit documentation retention policies and procedures necessary to provide reasonable assurance of compliance with PCAOB standards and applicable Commission rules pertaining to the retention of audit documentation.

3. Adopt all recommendations in the report of the Independent Consultant; provided, however, that within thirty (30) days after the Independent Consultant serves that report, Spicer Jeffries shall in writing advise the Independent Consultant and the Commission of any

recommendations that it considers to be unnecessary, unduly burdensome, impractical, or costly. With respect to any recommendation that Spicer Jeffries considers unnecessary, unduly burdensome, impractical or costly, Spicer Jeffries need not adopt that recommendation at that time but shall propose in writing an alternative policy, procedure, or system designed to achieve the same objective or purpose. As to any recommendation on which Spicer Jeffries and the Independent Consultant do not agree, such parties shall attempt in good faith to reach an agreement within thirty (30) days after Spicer Jeffries serves the written advice. In the event Spicer Jeffries and the Independent Consultant are unable to agree on an alternative proposal, Spicer Jeffries will abide by the determinations of the Independent Consultant;

4. 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 Spicer Jeffries, 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 this Order shall not, without prior written consent of the Salt Lake Regional Office, enter into any employment, consultant, attorney-client, auditing or other professional relationship with Spicer Jeffries, 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.

5. Certify, in writing, compliance with the undertakings set forth above. The certification shall identify the undertakings, provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Respondent agrees to provide such evidence. The certification and supporting material shall be submitted to Richard R. Best, Regional Director, Division of Enforcement, U.S. Securities and Exchange Commission, 351 So. West Temple, Suite 6.100, Salt Lake City, UT 84101 with a copy to the office of Chief Counsel of the Enforcement Division, 100 F Street, N.E., Washington, DC 20549-6553, no later than sixty (60) days from the date of the completion of the undertakings.

6. 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 Respondent Spicer Jeffries' Offer.

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

A. Respondent is censured.

By the Commission.

Brent J. Fields
Secretary

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

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

**INVESTMENT ADVISERS ACT OF 1940**
**Release No. 4302 / December 22, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17024**

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| **In the Matter of**<br><br>**RICHARD PEREIRA, CPA**<br><br>**Respondent.** | **ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS, MAKING FINDINGS, AND IMPOSING REMEDIAL SANCTIONS PURSUANT TO SECTION 203(f) OF THE INVESTMENT ADVISERS ACT OF 1940 AND 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 that public administrative proceedings be, and hereby are, instituted pursuant to Section 203(f) of the Investment Advisers Act of 1940 ("Advisers Act") and Rule 102(e)(2)[1] and (3)[2] of the Commission's Rules of Practice against Richard Pereira ("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

1 Rule 102(e)(2) provides in pertinent part: "Any . . . person who has been convicted of a felony or a misdemeanor involving moral turpitude shall be forthwith suspended from appearing or practicing before the Commission."

2 Rule 102(e)(3)(i) provides, in relevant part, that: "The Commission, with due regard to the public interest and without preliminary hearing, may, by order, . . . suspend from appearing or practicing before it any . . . accountant . . . who has been by name . . . permanently enjoined by any court of competent jurisdiction, by reason of his or her misconduct in an action brought by the Commission, from violating or aiding and abetting the violation of any provision of the Federal securities laws or of the rules and regulations thereunder."

Commission, or to which the Commission is a party, Respondent admits the Commission's jurisdiction over him and the subject matter of these proceedings, and the findings contained in Sections III.3. and III.4. below, and consents to the entry of this Order Instituting Administrative Proceedings, Making Findings, and Imposing Remedial Sanctions Pursuant to Section 203(f) of the Investment Advisers Act of 1940 and Rule 102(e) of the Commission's Rules of Practice ("Order"), as set forth below.

## III.

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

1. Respondent, age 42, resided in Ridgefield, Connecticut during the relevant period. During the period of the conduct described below, Respondent was the CFO of New Stream Capital, LLC ("New Stream"), an unregistered investment adviser in Ridgefield, Connecticut that at one time managed a $750-plus million hedge fund focused on illiquid investments in asset-based lending. Respondent is licensed as a CPA in New York.

2. On February 26, 2013, the Commission filed a Complaint ("Complaint") naming Respondent as a defendant in a civil action pending in the United States District Court for the District of Connecticut, SEC v. New Stream Capital, LLC, et al., Civil Action No. 3:13-cv-00264. The Commission's Complaint alleges, inter alia, that Respondent participated in a fraudulent scheme to mislead investors and advisory clients about the capital structure of a hedge fund managed and advised by New Stream.

3. On May 21, 2014, Respondent pled guilty to one count of conspiracy to commit wire fraud in violation of Title 18 United States Code, Section 371 before the United States District Court for the District of Connecticut, in United States v. Pereira, 3:13-cr-41 (JCH). On May 20, 2015, a judgment in the criminal case was entered against Respondent. He was sentenced to, among other things, a prison term of one year and one day followed by three years of supervised release.

4. On December 21, 2015, the United States District Court for the District of Connecticut entered, by consent, a final judgment against Respondent permanently enjoining him from future violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, Section 17(a) of the Securities Act of 1933, and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder.

## IV.

In view of the foregoing, the Commission finds that Respondent has been convicted of a felony within the meaning of Rule 102(e)(2) of the Commission's Rules of Practice and 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 203(f) of the Advisers Act that Respondent be, and hereby is barred from association with any broker, dealer, investment adviser, municipal securities dealer, or transfer agent.

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.

It is hereby further ORDERED pursuant to Rule 102(e)(2) and (3) of the Commission's Rules of Practice that Respondent is forthwith suspended from appearing or practicing before the Commission.

By the Commission.

Brent J. Fields
Secretary

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

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

**Release No. 34-76743; File No. S7-27-15**

**TRANSFER AGENT REGULATIONS**

**AGENCY**: Securities and Exchange Commission

**ACTION:** Advance notice of proposed rulemaking; Concept release; Request for comment

**SUMMARY:** The Securities and Exchange Commission ("Commission") is publishing this Advance Notice of Proposed Rulemaking, Concept Release, and Request for Comment on Transfer Agent Regulations ("release") to seek public comment regarding the Commission's transfer agent rules. The first transfer agent rules were adopted in 1977 and remain essentially unchanged. At the same time, transfer agents now operate in a market structure that bears little resemblance to the structure in 1977. The release, noting the importance of transfer agents within the national market structure, includes a history of transfer agent services and applicable regulations as well as an overview of current transfer agent services and activities, and requests comment on all topics. The release includes an Advance Notice of Proposed Rulemaking in specific areas, such as transfer agent registration and reporting requirements, safeguarding of funds and securities, and revision of obsolete or outdated rules, along with requests for comment, as well as a Concept Release and Request for Comment addressing additional areas of specific Commission interest, including processing of book-entry securities, broker-dealer recordkeeping for beneficial owners, transfer agents to mutual funds, and administration of issuer plans. The Commission intends to consider the public's comments in connection with any future

rulemaking, and comments to the Advance Notice of Proposed Rulemaking will be used to further consider the sufficiency and scope of the rulemaking proposals described therein.

**DATES:** Comments must be in writing and received by [insert 60 days from date of publication in the Federal Register]

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

*Electronic Comments*:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/concept.shtml);
- Send an email to rule-comments@sec.gov. Please include File Number S7-27-15 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 to: Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-27-15. 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/concept.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; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make publicly available.

**FOR FURTHER INFORMATION CONTACT:** Moshe Rothman, Branch Chief, Thomas Etter, Special Counsel, Catherine Whiting, Special Counsel, Mark Saltzburg, Special Counsel, Lauren Sprague, Special Counsel, or Elizabeth de Boyrie, Counsel, Office of Clearance and Settlement, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-7010 at (202) 551-5710.

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# I. INTRODUCTION

The United States' securities markets are indispensable to this country's and the world's economy. The Commission believes that issuers, investors, and other participants in the securities markets must be served by a well-functioning national system for the clearance and settlement of securities transactions ("National C&S System") that promotes safe, efficient, prompt, and accurate settlement transactions.[1] Critical to this mission is the development and maintenance of a comprehensive regulatory program that governs the functions of transfer agents and related industry segments critical to the proper functioning of the National C&S System, including entities that clear trades, provide custodial and safeguarding services, and perform other "back-office" functions within the securities industry.

As agents for issuers, transfer agents play a critical role with respect to securities settlement, though they rarely receive much public attention. Among their key functions, they may: (i) track, record, and maintain on behalf of issuers the official record of ownership of each issuer's securities; (ii) cancel old certificates, issue new ones, and perform other processing and recordkeeping functions that facilitate the issuance, cancellation, and transfer of those securities; (iii) facilitate communications between issuers and registered securityholders; and (iv) make dividend, principal, interest, and other distributions to securityholders. A transfer agent's failure to perform its duties promptly, accurately, and safely can compromise the accuracy of an issuer's securityholder records, disrupt the channels of communication between issuers and

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1 See infra Sections II and III of this release for additional discussion of the National C&S System.

securityholders, disenfranchise investors, and expose issuers, investors, securities intermediaries, and the securities markets as a whole to significant financial loss.[2]

The securities markets and the National C&S System in which transfer agents operate have changed significantly since the Commission first began regulating transfer agents in the 1970s. The changes largely reflect a decades-long evolution from a manual securities settlement process focused on the processing of physical securities certificates to a highly automated electronic environment centered on the processing and transfer of electronic book-entry securities.[3] The changes also reflect significant technological and operational developments in other areas, as well as broader changes in the securities industry and the business and regulatory environments in which transfer agents operate.

As a result, the Commission has observed over time that transfer agents now perform a more diverse array of functions and services, many of which may not be fully addressed by the Commission's transfer agent rules. In addition, the Commission has observed that the manner in which transfer agents carry out their traditional functions may no longer be adequately addressed in the rules. The Commission's consideration of these observations has led it to include two interrelated approaches in this release. Under the first approach, the Commission believes it has

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2 Maintenance of Accurate Securityholder Files and Safeguarding of Funds and Securities by Registered Transfer Agents, Exchange Act Release No. 19142, 2-3 (Oct. 15, 1982), 47 FR 47269 (Oct. 25, 1982) ("17Ad-9 through 13 Proposing Release") (noting examples of substandard transfer agent performance presenting significant potential adverse consequences). See also Processing Requirements for Cancelled Security Certificates, Exchange Act Release No. 48931 (Dec. 16, 2003), 68 FR 74390, 74391 (Dec. 23, 2003) ("17Ad-19 Adopting Release") (noting examples of substandard transfer agent performance and significant adverse consequences).

3 Concept Release on Equity Market Structure, Exchange Act Release No. 61358, 2 (Jan. 14, 2010), 75 FR 3594, 3594 (Jan. 21, 2010). When securities are referred to as being in "book-entry" form, it means that the investor does not receive a certificate. Instead, a custodian, usually a broker or transfer agent, maintains electronic records showing that the investor owns the particular security. For additional discussion of book entry securities, see infra note 37.

identified a series of new and amended rules that, based on its current understanding of transfer agents and their functions, it intends to propose. These anticipated new and amended rules, which the Commission intends to propose as soon as is practicable, either individually or in groups or phases, and irrespective of any other changes to the transfer agent rules, are discussed in detail in the Advance Notice of Proposed Rulemaking found in Section VI. The Commission is soliciting public comment on the anticipated rulemaking proposals described in Section VI. Public feedback and data would assist the Commission in further refining and calibrating the anticipated proposals as well as other potential proposals.

Under the second approach, reflected in the Concept Release and Request for Comment contained in Section VII, the Commission discusses and requests comment regarding a number of additional transfer agent issues that primarily arise from the diverse array of transfer agent functions and services which have developed over time. Public comment on these additional issues will allow the Commission to evaluate the need for, and potentially develop, additional rulemaking proposals appropriately tailored to these complex areas. In undertaking these approaches, the Commission remains sensitive to whether any distinctions between the actual activities of transfer agents and what is contemplated by the Commission's rules may create undue uncertainty or risks for the National C&S System and the market participants that rely upon it, including investors, issuers, regulators, and transfer agents. As transfer agents continue to evolve in their roles and activities, any such distinctions, and the commensurate risks associated with them, may also grow.

We begin with an overview of the antecedents, advent, and subsequent history of the National C&S System, including a discussion of the "Paperwork Crisis" which helped precipitate the legislative amendments that gave rise to that system. We then describe the National C&S

System and transfer agents' role within that system as it functions today, followed by a discussion of the current regulatory regime and the core functions performed by transfer agents. The remainder of the release consists of the two sections noted above: the Advance Notice of Proposed Rulemaking in Section VI and the Concept Release and Request for Comment in Section VII.

We are mindful that the role of transfer agents in the National C&S System and the need to address specific risks associated with transfer agents have been topics of discussion and debate, both within and outside the Commission, for many years.[4] We intend for this release to build on those discussions and therefore invite comment on the full range of topics and issues associated with transfer agents and their activities, regardless of whether and in which section those topics and issues are specifically addressed. Thus, while we set forth specific requests for comments, we welcome comments on any concerns related to transfer agent activities, the transfer agent regulatory program, or other areas of concern that commentators may have. We specifically invite comment on any possible regulatory actions regarding the issues and concerns described, including potential new rules or rule amendments or other reasonable regulatory alternatives, as well as any related evidence, quantitative and/or qualitative, relating to a potential regulatory action. Comments received on either or both sections of the release will be considered in connection with any future rulemaking.

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4 For example, in 2011 the Commission hosted a roundtable on the execution, clearance, and settlement of microcap securities which covered, among other topics, the role of transfer agents in the issuance and transfer of restricted securities. See transcript, available at https://www.sec.gov/spotlight/microcap/microcaproundtable101711-transcript.txt.

We are also mindful that market developments have occurred beyond the changes that are the focus of this release and that affect transfer agents. For example, transfer agents and market participants now often communicate with one another using structured data on electronic platforms. Data standardization efforts have emerged to further enhance these electronic communication methods, such as the international standards effort focusing on corporate actions, which may ultimately be used by transfer agents.[5] Although these issues are not specifically addressed herein, comments on, and specific data about, any such developments are welcome.

The Commission is sensitive to the effects that could result from any regulatory action, and accordingly we also seek input on the economic effects or tradeoffs associated with any potential regulatory action, including any costs, benefits, or burdens of such action, and any effects on efficiency, competition, and capital formation. We are also mindful that the various aspects of the transfer agent regulatory program and securities transfer process that we address in this release are interconnected, and that changes to one aspect may affect other aspects, as well as complement or frustrate other potential changes. Therefore, we encourage the public to consider these relationships when formulating comments, and invite comment on whether alternative approaches, or a combination of approaches, would better address the concerns raised.

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5 See, e.g., XBLR: The Business Reporting Standards, https://www.xbrl.org/the-consortium/get-involved/corporate-actions-working-group/.

# II. THE NATIONAL CLEARANCE AND SETTLEMENT SYSTEM: HISTORY AND BACKGROUND

## A. Transfer of Certificated Securities

Investment securities confer certain intangible rights and benefits upon the holder.[6] For example, the rights and benefits represented by a share of stock generally include the right to share in the capital and surplus of the corporation and receive certain other benefits and specified rights. Because securities confer intangible rights, historically the transfer of investment securities from one person to another has required special rules. In the past, the most common way to transfer investment securities, such as shares of stock, was to transfer a paper certificate that represents the benefits of ownership ("certificated security").[7] Certificated securities have been issued in the United States since the 1700s[8] and are evidence that the owner is registered on the books of the issuer (or its transfer agent) as a securityholder.[9] Although the shares themselves represent an intangible right,[10] the certificate is a negotiable instrument under state

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6 Egon Guttman, Modern Securities Transfers § 1:5 (4th ed. 2010).

7 The Uniform Commercial Code ("UCC") defines a "certificated security" as "a security that is represented by a certificate." U.C.C. 8-102(a)(4). The UCC, which was first published in 1952, is a uniform act designed to standardize the law of sales and other commercial transactions in all 50 states. The UCC has the effect of law only when adopted by a state, and while it has been adopted by all 50 states, there are numerous state-by-state variations in the adopted texts.

8 The first major American issue of publicly traded securities occurred in 1790 when the federal government issued $80 million of bonds to refinance federal and state Revolutionary War debt. In 1792, five securities—two bank stocks and three government bonds—began trading on what was to become the New York Stock Exchange. For a historical discussion of the development of trading on the exchange, see Teweles and Bradley, The Stock Market 95-119 (6th ed. 1992).

9 Guttman, supra note 6.

10 Id.

law, which allows the registered owner of the certificated security to transfer the bundle of intangible rights to a third party.[11]

This ability to transfer the rights associated with share ownership helps drive the securities markets.[12] Generally, under the UCC, "voluntary transfer of possession" is all that is required to effect such a transfer.[13] But in order to qualify as a "protected purchaser" under the UCC, and therefore acquire an interest in the security free of any adverse claim, the buyer must give value, not have notice of any adverse claim to the security, and obtain control of it.[14] Thus, for a buyer of registered certificated securities to achieve protected purchaser status, the voluntary transfer of possession could involve a significant amount of paperwork and manual processing, even in a direct transaction between a seller and a buyer:

> [E]ither the certificate or a stock power must be indorsed, the signature guaranteed, authority to transfer title documented, and the stock certificate and the other documentation delivered, not to mention the registration of transfer on the stockholders list, the destruction of the old certificate and the issue of a new one.[15]

Historically, transactions involving certificated securities effected on securities exchanges could be significantly more complex:

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11 Id. at § 1:12.

12 Generally, the UCC governs the transfer of securities. For further discussion of the UCC, see Section IV.D.

13 Guttman, supra note 6, at § 1.11, U.C.C. 1-201(b)(14).

14 U.C.C. 8-303. "Control" over a registered security is achieved by obtaining control of the security indorsed to the holder or in blank, or if the issuer registers the holder in the securityholder list. See U.C.C. 8-106(b), off. cmts. 2-3.

15 David C. Donald, The Rise and Effects of the Indirect Holding System: How Corporate America Ceded Its Shareholders to Intermediaries 7 (Sept. 27, 2007), available at http://ssrn.com/abstract=1017206.

> In sales and purchases by persons other than brokers and specialists, the owner of the security will instruct a broker to sell, the broker will transfer the order to the exchange floor/system or a market maker, where it will be matched wholly or partially with one or more buy orders. Once the order is executed, the seller will have to deliver the executed certificate(s) to his broker so that the selling broker can deliver it to the buying broker, market maker, specialist, or central counterparty. Once the buying broker receives delivery, she will have to deliver to the issuer's transfer agent with a request for registration of transfer on the stockholder list. The latter, after inspecting all necessary documentation, will register the transfer, cancel the old certificate, and issue a new certificate to the buyer. Thus, beyond indorsement of the certificate and its delivery, each stage of the transaction will demand the documents, guarantees and assurances that constitute "good delivery" on the respective exchange.[16]

B. Transfer Agent Processes For Transferring Certificated Securities

Historically, from the transfer agent's perspective, the transfer of certificated securities held by registered owners was a time-consuming manual process. First, the transfer agent would receive from the broker a bundle of documents (the "transfer bundle") that typically included the following: (i) a "ticket" pinned to the bundle of documents that served as a transmittal letter and receipt;[17] (ii) transfer instructions telling the transfer agent what action to take; (iii) the security

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16 Id. at 7-8.

17 Historically, the term "ticket" referred to a broker-originated window ticket, which indicated the identity of the delivering broker, the securities, and the quantity. It would be prepared by a broker in triplicate and accompanied the transfer instructions and stock certificates when presented by the broker to the transfer agent for transfer. SEC, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 92-231, at 182 n.32 (Dec. 1971) ("Unsafe Practices Study"). Today, a ticket may provide similar information, either in electronic form, or in a highly structured and standardized paper form capable of being scanned and converted to electronic form.

certificates of the selling securityholder; (iv) a power of attorney;[18] and (v) a "guarantee," typically affixed to the power of attorney or certificate, guaranteeing the genuineness of the signature of the selling securityholder indorsing the certificate over for transfer.[19]

As an example of the extensive process for transferring certificated securities, prior to 1975, for New York City transfer agents, nearly 90 percent of these transfer bundles were received from messengers at the transfer agent's "window," which was a physical drop-off location at the transfer agent's offices, rather than through the mail, in which case the transfer bundles would be routed to the mail room.[20] Upon receipt at the window, the transfer agent would perform a visual reconciliation to confirm that the number of securities shown on the ticket matched the number on the certificates. If the transfer agent found a difference, the transfer would be rejected as "out of balance" and returned to the broker, a process known as a "window rejection."[21] If no difference was found, the transfer agent would continue the process with a more detailed inspection, starting with a detailed review of signature guarantees,

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18 A power of attorney may also be referred to as a "stock power" (or "bond power" with respect to debt securities) and grants legal authority to the registered securityholder's broker, to a transfer agent, or to another intermediary to transfer the securityholder's securities ownership on behalf of the securityholder. A seller may use a power of attorney rather than indorse the assignment and transfer form on the back of the security certificate. For examples of forms of transfer and assignment (i) by stock power; (ii) by bond power; and (iii) by execution of the transfer and assignment form on the back of a security certificate, see Mark S. Rhodes, Transfer of Stock app. A § 678.3041 at forms 1-3 (7th ed. Apr. 2015).

19 North American Rockwell Information Systems Company, Securities Industry Overview, Final Report to the American Stock Exchange 47 (1969) ("Rockwell Study").

20 It was estimated at the time that New York transfer agents only received approximately 10 percent of certificates by U.S. mail. The pattern was the opposite for transfer agents outside of New York, which were estimated to receive the vast majority of certificates for transfer through the mail. Id. at 51.

21 Id. at 47-52.

indorsements,[22] and attachments in order to determine if the certificates were in "good order" for transfer.[23] If the transfer agent found a deficiency, it would attach a rejection sheet to the certificate in question and return it to the broker, a process referred to as an "examination rejection."[24] If the certificates were found to be in good order, the transfer agent would perform "stop checking," the process of verifying each certificate number against a file it maintained listing certificates reported stolen, missing,[25] or with "stop transfers" or legal holds.[26]

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22 Transfer agents may have reviewed indorsements but generally did not maintain signature cards for each registered securityholder or otherwise verify authenticity of the signature by comparing it to specimen signatures. Rather, the signature guarantee provided by the broker was intended to provide assurance concerning the authenticity of the seller's signature. Today, the signature guarantee process has been enhanced and standardized through non-governmental Medallion guarantee programs. For additional information regarding Medallion guarantees, see infra note 267.

23 Rockwell Study, supra note 19, at 53.

24 It was estimated that, in the mid- to late-1960s, window rejections were as high as 20 percent and examination rejections were as high as 30 percent. Id.

25 Id. Today, there is a national system operated by the Securities Information Center ("SIC") as the Commission's designee for maintaining a database concerning missing, lost, counterfeit, and stolen securities that "reporting institutions" (brokers, dealers, registered transfer agents, certain types of banks, and others) report information to and inquire into concerning the status of securities certificates. See Exchange Act Rule 17f-1, 17 CFR 240.17f-1. However, transfer agents still maintain their own lists of securities subject to stop transfers. For additional discussion of reporting requirements for lost and stolen securities, see infra Sections IV.A.1 and IV.A.2.

26 A "stop transfer" or a "stop order" is a demand made by a registered securityholder to an issuer that a security should not be transferred without the securityholder having an opportunity to assert a claim to the security, typically because the security has been destroyed, lost, or stolen. See U.C.C. 8-403; Guttman, supra note 6, at § B:11, form 62 (providing a form of stop transfer notice). Under U.C.C. 8-403, an owner's notification that a security certificate has been lost constitutes a demand that the issuer not register transfer. U.C.C. 8-403, cmt. 2 (2005). If, after a stop transfer demand has become effective, a certificated security in registered form is presented to an issuer with a request to register transfer (or an instruction is presented to an issuer with a request to register transfer of an uncertificated security), the issuer must promptly provide a notice with certain information to both the person who made the stop transfer demand and the person seeking to transfer the security. See U.C.C. 8-403(b). When a security has been destroyed, lost, stolen, or is otherwise missing, in addition to providing a stop transfer notice, a registered securityholder commonly will seek to replace the security. The process of replacement is described in detail infra in Section IV.A.2.

The next step was to prepare the transfer journal entries documenting the cancellation of the old certificate and the issuance of the new certificate.[27] Entering information into the transfer journal was considered the most time consuming part of the transfer process because it was a manual process, requiring gathering discrete pieces of information from different documents in the transfer bundle.[28] Concurrently, the transfer agent would cancel the old certificate and prepare a new certificate from the supply of blank certificates the transfer agent kept on hand.[29]

Prior to sending certificates to a registrar, the transfer agent's staff would perform several audits to verify the accuracy of the transfer journal and new certificate.[30] After completion of these audits, the transfer agent would send the certificates to a registrar, which would perform an additional audit or quality control check primarily focused on verification that the share quantities on the cancelled certificates and newly issued certificates matched and that the new certificates were not issued in a manner resulting in an overissuance.[31] If the registrar was independent of the transfer agent, as historically required by certain stock exchange rules, the transfer agent would remove the window tickets from batches of securities to be sent to the

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27 This record may also be referred to as a "transfer blotter," or a "transfer log," among other terms. As used throughout this release, we refer to it as a "transfer journal." A transfer journal is a continuous record of the transfer of ownership of securities, including the identity of the party presenting the item for transfer, whether the transfer was completed, and to whom the securities were made available

28 Rockwell Study, supra note 19, at 53.

29 Id. at 53-54, 57. These blank certificates typically would have been ordered by a corporate officer of the issuer and been engraved by a bank note company before being delivered to the transfer agent. The engraving was both aesthetic and a security feature designed to prevent counterfeiting. Id. at 100. To avoid trading interruptions caused by running out of certificates, transfer agents had to carefully forecast certificate demand and monitor their inventory of blank certificates. Id. Today, it is the understanding of the Commission's staff that some certificates may not be engraved but are produced by transfer agents through "print-on-demand" services.

30 Id. at 53. For additional discussion of the registrar function, see, e.g., infra Section II.C.1

31 Id. at 53-54. For more information regarding overissuances, see infra note 235 and accompanying text.

registrar, sequence the batches of old and new certificates separately by security issue, and send the bundles by messenger to the registrar, typically overnight.[32] The registrar would perform the audit described above, countersign the new certificates,[33] and then return them to the transfer agent.[34] The transfer agent would then need to reorganize the certificates and reattach them to their window tickets before sending the new certificates and accompanying documents to the designated receiving party, usually by messenger.[35]

In 1977, the concept of the "uncertificated security" was introduced in Article 8 of the UCC.[36] This innovation allowed issuers to issue uncertificated (i.e., certificateless) book-entry securities, the transfer of which is greatly simplified compared to the transfer of certificated securities because transfer can be effected and protected purchaser status can be achieved by simply registering the transferee's name on the books of the issuer.[37]

C. Paperwork Crisis of the 1960s

Prior to 1968, individual clearing brokers[38] found it necessary to maintain a relationship with a separate clearing agency for each securities exchange.[39] In the over-the-counter ("OTC")

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32 Id. at 53.

33 Before the new certificate would be sent out to the designated receiving party, the transfer agent would also countersign the new certificate. Thus, new certificates typically would include the signature of an officer of the issuer and countersignatures by the transfer agent and registrar.

34 Rockwell Study, supra note 19, at 53.

35 Id.

36 See U.C.C. 8-102(a)(18) (defining new term uncertificated security as "a security that is not represented by a certificate"); U.C.C. 8-101 (citing "Reasons for 1977 Change," and introducing the subject of uncertificated securities). See also Egon Guttman, Toward the Uncertificated Security: A Congressional Leap for States to Follow, 37 Wash. & Lee L. Rev. 717, 729-32 (1980).

37 Guttman, supra note 6, at § 6:4. Book-entry securities are discussed in more detail throughout the release, including in Sections III.A and VII.A.

38 For further information on introducing and clearing brokers, see Figure 1 and accompanying text, infra.

market,[40] most securities transactions were settled without going through a clearing agency or were cleared by small user-owned clearing corporations. In either instance, brokers had to settle most transactions by physical delivery or receipt of certificates, and had to maintain an office or establish a correspondent relationship with an entity with an office near the clearing agency.

As trading volume increased throughout the 1960s and early 1970s, the burdensome manual process associated with transferring certificated securities created what came to be known as the Paperwork Crisis. It was, at the time, "the most prolonged and severe crisis in the securities industry"[41] since the Great Depression and to this day is one of the largest challenges the U.S. securities markets have faced. The manual settlement processes for certificated securities could not keep up with increasing trading volumes, deliveries to customers of both cash and securities were frequently late, and stock certificates were lost in the rising tide of paper. The substandard performance of transfer agents was "a significant contributing factor" to

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39 A clearing agency may be referred to as a clearing corporation or a depository, depending on its functions. Clearing corporations typically compare member transactions, clear, net and settle trades, and provide risk management services, such as trade guarantees. Depositories immobilize securities by holding them on deposit for their participants and effect transfers of interests in those securities through book-entry credits and debits of participants' accounts at the depository. For additional discussion, see infra Section III. See also, e.g., Exchange Act Section 3(a)(23)(A), 15 U.S.C. 78c(a)(23)(A) (defining the term "clearing agency"); Clearing Agencies, SEC, https://www.sec.gov/divisions/marketreg/mrclearing.shtml (last visited Nov. 25, 2015). Currently, DTC is both the only CSD in the United States and the only CSD registered with the Commission as a clearing agency. See Exchange Act Section 3(a)(23)(A), 15 U.S.C. 78c(a)(23)(A) (requiring CSDs to register with the Commission as a clearing agency).

40 The term "OTC" refers generally to securities that are not listed on a national securities exchange. Many equity securities, corporate bonds, municipal securities, government securities, and certain derivative products are traded in the OTC market. The OTC Bulletin Board ("OTCBB"), which is a facility of FINRA, for example, is an electronic inter-dealer quotation system that displays quotes, last-sale prices, and volume information for many securities that are not listed on a national securities exchange, including domestic, foreign and American depository receipts (ADRs). For additional discussion, see, e.g., Over the Counter Market, SEC, https://www.sec.gov/divisions/marketreg/mrotc.shtml (last visited Nov. 20, 2015).

41 Unsafe Practices Study, supra note 17 at 1.

the Paperwork Crisis.[42] At times during 1967 and 1968, the New York Stock Exchange ("NYSE") closed early on some days and during a substantial portion of 1968 closed entirely on Wednesdays to attempt to allow the brokerages and other firms to keep up with the volume.[43]

In the immediate aftermath of the Paperwork Crisis, more than 100 broker-dealers went bankrupt or were acquired by other firms and "[t]he inability of the securities industry to deal with its serious operational problems . . . contributed greatly to the loss of investor confidence in the efficiency and safety of [the U.S.] capital markets."[44] However, other consequences of the Paperwork Crisis were deeper and longer lasting. As discussed below, over the next years and decades, Congress, federal and state regulators, and industry participants, including brokers, dealers, banks, and securities exchanges, worked together to drastically reshape critical operational aspects of the securities industry, ultimately leading to major revisions to both federal and state securities laws, and the advent of the modern national market system and National C&S System as they exist today.

### *1. Industry Responses (1968-1970)*

Formation of the Central Certificate Service (1968)

In immediate response to the Paperwork Crisis, regulators and industry participants studied and adopted alternative settlement systems and other potential options which might

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42 Id. at 37-8.

43 Id. at 219, n. 4. See also New York Stock Exchange, Inc., Crisis in the Securities Industry, A Chronology: 1967-1970 10-16 (1971) (report prepared for the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce of the U.S. House of Representatives).

44 S. Rep. No. 94-75, at 3-4 (1975) ("Senate Report on Securities Act Amendments of 1975") (report prepared by the Senate Committee on Banking, Housing, and Urban Affairs on the Securities Act Amendments of 1975). For additional information about the Paperwork Crisis, see also Unsafe Practices Study, supra note 17, at 13-30; Securities Transaction Settlement Concept Release, Exchange Act Release No. 49405 (Mar. 11, 2004), 69 FR 12922 (Mar. 18, 2004).

reduce or eliminate the problems associated with the traditional process for transferring certificated securities. First, in June 1968, the NYSE established the Central Certificate Service ("CCS") as a division of the Stock Clearing Corporation. Broker-dealers and banks who were members of the NYSE were permitted to deposit their certificated securities with CCS, which would hold the certificates in custody and transfer them into the name of a CCS nominee.[45] The certificated securities deposited by that member would be represented by an appropriate book-entry credit reflected in that member's account at CCS. Because all securities held by CCS were registered in its nominee's name, deliveries of securities between CCS members could be effected by appropriate credits and debits to the members' securities accounts rather than by physical delivery of certificates. In this manner members' accounts would be debited and credited to reflect transactions among them, but the registered owner of the securities – CCS's nominee – would never change. Movement of certificates was thus eliminated, resulting in their "immobilization."[46] At the time, CCS was the most prominent example of the central securities depository model discussed below in Section II.B.2. In 1970, CCS opened its services to

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45 Unsafe Practices Study, supra note 17, at 184. The registration of securities into the name of a nominee rather than the name of the investor is commonly referred to as "street name" registration, which stands for "Wall Street name." See The Stock Market, supra note 8, at 249-251, 307. A nominee is usually a partnership formed exclusively to act as the record holder of securities and thereby to facilitate their transfer. See Preliminary Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other than the Name of the Beneficial Owner of Such Securities 2-15 (Dec. 4, 1975) ("Preliminary Street Name Study") (providing extensive discussion of the history of the practice of nominees and street name ownership, the scope of the practice, the concept of beneficial ownership and then-current practices). For further discussion of registered ownership and street name ownership (or beneficial ownership), see infra Section III.A. See also infra note 87, regarding DTC's nominee, Cede & Co.

46 Unsafe Practices Study, supra note 17, at 184.

members of the American Stock Exchange,[47] and in 1973 CCS changed its name to the Depository Trust Company ("DTC").[48]

Rockwell Study (1969)

Around the same time, the American Stock Exchange hired the North American Rockwell Information Systems Company to study and appraise the securities industry's operations. In 1969, it produced the Rockwell Study. Among other things, the Rockwell Study found that the securities industry's operations were unnecessarily complicated and had not kept pace with technology and recommended that the actual physical movement of securities be reduced.[49]

To address unnecessary complexity, for example, the Rockwell Study focused on whether more efficient clearance and settlement of securities could be achieved by allowing single entities to perform both registrar and transfer agent functions. If so, the entity would need to function in a way that still would preserve the independent audit and shareholder protection function that a registrar historically was viewed, by many participants in the securities industry, as providing.[50] However, at the time when the Commission adopted the majority of its transfer

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47 The American Stock Exchange, a major New York securities exchange founded in 1908, operated for a century before being acquired by the New York Stock Exchange and ceasing operations as an independent entity in 2008.

48 For further discussion of DTC, see infra Sections II.C.3, III.B, IV.C.2.

49 Rockwell Study, supra note 19.

50 See, e.g., Rockwell Study, supra note 19, at 101.

agent rules in 1977 and 1983, independent registrars were still present in the marketplace and indeed were required by the NYSE until 1984.[51]

To reduce the physical movement of securities, the Rockwell Study recommended the establishment of individual transfer agent depositories ("TADs"), which was, at the time, a theoretical proposal that had not been implemented in any market.[52] As proposed, the TAD model would have established a national clearing system together with a decentralized network of individual transfer agent depositories. Securityholders would immobilize their certificated securities by depositing them for custody with the transfer agent for the issuer, effectively making each transfer agent an independent depository for its respective issuers. The transfer agent would maintain the issuer's register, or records of registered shareholders, in electronic form on behalf of the issuer and would settle transactions by debiting and crediting the securities accounts of the respective parties to the transaction on the issuer's register instead of delivering physical certificates.[53] Thus, the account on which transfers took place would also be the issuer's register, which would allow transfers to be effected by simply removing the seller's name from the register (i.e., debiting the seller's securities account) and adding the buyer's name (i.e., crediting the buyer's securities account). The national clearing system proposed under the TAD model would settle all securities transactions, both exchange and OTC trades, by receiving

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51 However, at that time, the American Stock Exchange did not require an independent registrar. Rockwell Study, supra note 19, at 101. In 1984, the Commission issued an order that approved an NYSE rule change that eliminated the requirement to use a separate transfer agent and registrar, subject to certain conditions. Securities Exchange Act Release No. 21499 (Nov. 19, 1984) (File No. SR-NYSE-84-33).

52 Rockwell Study, supra note 19, at 3, 9, 14, 31, 39, 43, 77, 98.

53 Rockwell Study, supra note 19, at 39-43.

the compared trades[54] directly from the floor of the exchange and receiving OTC trades by messenger or other delivery service.[55] Compared trades would then be transmitted to the appropriate TAD, where, as noted above, the respective accounts of the parties would be credited and debited.[56] As with the CCS system established by the NYSE, the movement of certificates would be eliminated, resulting in their immobilization.

Arthur Little Study (1969)

From July 1968 to April 1969, Arthur D. Little & Co. conducted a study for the National Association of Securities Dealers ("NASD") on the problem of settlement fails,[57] titled, "The Multiple Causes of Fails in Stock Clearing in the United States With Particular Emphasis in Over-The-Counter Securities" ("Arthur Little Study"). Among other things, the Arthur Little Study compared the performance of two different types of clearing systems: (a) the "balance order system" used by the New York, American, and National OTC Clearing Corporations, and (b) the "net by net" or "continuous netting system" used by the Pacific Coast Stock Clearing Corporation and the Midwest Stock Exchange Clearing Corporation.[58] The study showed that

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54 Trade comparison, resulting in a compared trade, is the post-execution act of matching the two sides of a trade and confirming the existence of a contract and the trade's exact terms (security, parties, time of trade, number of units, and price), usually by the exchange. It is generally regarded as the first step in the clearance and settlement process. See The October 1987 Market Break, A Report by the Division of Market Regulation, 10-2, 10-4 (1988) ("October 1987 Market Break Report").

55 Unsafe Practices Study, supra note 17, at 180.

56 Id.

57 A settlement fail occurs if a seller does not deliver securities or a buyer does not deliver funds owed by the settlement date.

58 See Arthur D. Little, Inc., The Multiple Causes of Fails in Stock Clearing in the United States 2414, 21-22 ("Arthur Little Study"). In the balance order system, after comparing the trades completed for the day by each clearing corporation participant, the clearing corporation would net each participant's trades in each security and issue orders for the net sellers to deliver, and the net buyers to receive, specific amounts of securities at the established settlement price directly from other participants. The duty to deliver and the

the balance order system could reduce securities movement by approximately 25 percent and the continuous netting system could result in a 50 percent reduction.[59] The Arthur Little Study, along with the NASD, concluded that the best nationwide clearance and settlement system would be one consisting of interconnected regional clearing centers, each using the net by net (or continuous net settlement) system.[60]

Formation of the National Clearing Corporation (1969)

In December 1969, the NASD formed the National Clearing Corporation ("NCC") as the vehicle for developing and implementing a nationwide system of interconnected regional clearinghouses that would form a national OTC clearing system utilizing continuous net settlement. NCC took over the operations of the National Over-the-Counter Clearing Corporation and eventually grew to include OTC transactions in all issues listed on exchanges or included on the NASDAQ system.[61] In 1977, NCC merged with the clearing facilities of both the NYSE and the American Stock Exchange to form the National Securities Clearing

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duty to receive would be allocated in such a way that, for each issue traded, the net seller would have to make only one delivery and the net buyer would receive only one delivery, which could result in participants receiving from or delivering to other participants with whom they did not transact that day. In the net by net (or continuous net settlement system), each of the participant's trades in every security were netted for that day, so that each participant would be either a net seller or a net buyer for a particular security, and the duty to deliver the net sales or receive the net purchase would be added to any outstanding deliver or receive obligations of that participant in that security. In addition, all deliveries and receipts would be made to or from the clearing corporation, rather than between other participants, as in the balance order system. Unsafe Practices Study, supra note 17, at 167 n.6.

59 Unsafe Practices Study, supra note 17, at 167 n.6, 172.

60 Id. at 174-5.

61 NASDAQ stands for National Association of Securities Dealers Automated Quotations and was founded in 1971 by the NASD as an electronic quotation system. It later developed into an electronic stock market, primarily focused on the OTC market and today is registered with the Commission as a national securities exchange under Section 6 of the Exchange Act. See Exchange Act Section 6, 15 U.S.C. 78f; Teweles, supra note 8, at 4-5, 371-2.

Corporation ("NSCC"). The new entity provided clearing, settlement, risk management, and other services, including continuous net settlement of trades and payments, to its participants.

BASIC Study (1970)

In early 1970, around the same time that CCS extended its services to the American Stock Exchange, the Banking and Securities Industry Committee ("BASIC") was formed by banking and securities industry participants to find solutions to problems affecting both those industries.[62] After more than a year of review and analysis, BASIC advocated the immobilization of securities certificates through a "Central Securities Depository System for the entire securities industry comprised of regional depositories with an inter-connection between the depositories."[63] There was also agreement that "the certificate must be eliminated, but that this will take time."[64]

### 2. *Regulatory and Industry Responses (1971-1975)*

Unsafe Practices Study (1971)

In 1970, Congress enacted the Securities Investor Protection Act of 1970 which established the Securities Investor Protection Corporation for the broad purpose of affording financial protection for the customers of registered brokers and dealers.[65] The act also directed the Commission to conduct a study into the causes and potential responses to the Paperwork

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62 BASIC was formed in March 1970 as an outgrowth of a joint committee established between representatives of the securities and banking industries in 1968. BASIC was sponsored by the NYSE and American Stock Exchange, the NASD, and the 11 New York Clearing House banks. Securities Industry Study, H.R. Rep. No. 92-1519, 64 (1972) ("Securities Industry Study").

63 Unsafe Practices Study, supra note 17, at 171. See also id. at 184-188.

64 Id. at 173.

65 The Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636 (Dec. 30, 1970), 15 U.S.C. 78aaa; S. Rep. No. 91-1218 (1970) (Report to Accompany S. 2348).

Crisis.[66] In response, the Commission held meetings, a conference, and hearings that included participation by market participants and federal bank regulators to identify and correct operational and financial problems in the securities industry, and then produced the Unsafe Practices Study.[67] The Unsafe Practices Study in part concluded that the inherent inefficiencies and risks associated with the processing of physical securities certificates contributed to the Paperwork Crisis, and it was therefore necessary to reduce the amount of paperwork connected with securities transfers.[68] There was disagreement, however, regarding the best way to accomplish this goal.

Although it was generally recognized at the time that the complete elimination of certificated securities, known as "dematerialization," was the best approach to eliminating the risks associated with the processing of physical securities, due to technological and legal impediments, dematerialization was viewed as a "utopian solution" that "would require very extensive legal work and lead time to implement."[69] Indeed, as noted above, two of the leading proposed securities settlement models designed to reduce the amount of paperwork being discussed at that time – the central depository system represented by CCS and the TAD system – would have resulted in the immobilization of securities rather than dematerialization, and

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66 15 U.S.C. 78kkk(g). See also Unsafe Practices Study, supra note 17, at 11.

67 See Unsafe Practices Study, supra note 17, at 31 (discussing a meeting of major SROs to discuss operational capacity in the securities industry, a conference on the stock certificate, a series of meetings with federal bank regulators regarding the regulation and performance of transfer agents, and hearings concerning restructuring of the securities markets).

68 Id. at 28.

69 Id. at 173, 194-95. For example, Delaware did not permit the issuance of "certificateless stock" until Section 158 of the Delaware General Corporation Law was amended in 1983. See Welch, Turezyn, and Saunders, Folk on the Delaware General Corporation Law §158.4 (5th ed. 2013).

therefore were viewed as "interim measures for efficient operations" that could be taken immediately but would also "serve as building blocks for that ultimate objective" of dematerialization.[70]

While there was widespread industry support for the TAD model, there were legal and technological impediments to its immediate implementation.[71] In contrast, the central depository system model had already been established on a limited basis as the CCS established by NYSE, although it had not been implemented on a national basis. The proposal being discussed at the time would use CCS as a starting point and gradually expand it into a New York central securities depository that would link to similar regional depositories of other major financial centers, thus resulting in each depository having an account at the others.[72] This would allow members of one depository to transact with members of, and effect the delivery of securities via, the other depositories.[73] Under this approach, no one depository would be restricted solely to the specific members or securities listed on a particular exchange. Like the TAD, this approach resulted in immobilization rather than dematerialization, but instead of a decentralized network of transfer agents acting as individual depositories for issuers, all paper securities certificates for all issuers would be deposited into one or more central pools and kept in custody by such central depositories. Under this model, the more certificates deposited into a central depository, the more efficient the system would be.

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70 Unsafe Practices Study, <u>supra</u> note 17, at 173.

71 Unsafe Practices Study, <u>supra</u> note 17, at 173, 183-4, 194-5.

72 Unsafe Practices Study, <u>supra</u> note 17, at 184-5.

73 <u>Id.</u> at 185.

Securities Industry Study (1973)

Following publication of the Commission's Unsafe Practices Study, the Senate Subcommittee on Securities conducted its own 18-month study, which resulted in the Securities Industry Study of 1973 Report ("Securities Industry Study").[74] The Securities Industry Study found "two primary functional causes" for the Paperwork Crisis: (i) the securities industry had failed to develop a nationwide system for clearance and settlement of securities transactions; and (ii) there existed a lack of uniformity and coordination among the various methods of clearing and settlement in use. The Securities Industry Study's recommendations included the following: (i) that the Securities Exchange Act of 1934 ("Exchange Act") be amended to "make it clear" that the Commission has the "power and the responsibility to direct the evolution of clearance and settlement methods employed by the national securities associations and by broker-dealers engaged in interstate commerce;" (ii) that legislation should "requir[e] clearing agencies and depositories to register with and report to the SEC and empower the Commission to review and amend the rules of such entities;" (iii) that "the Commission be directed to proceed with dispatch toward elimination of the stock certificate as a means of settlement between broker-dealers…"; and (iv) that "the Commission be directed to consider the practice of registering securities in 'street name….'"[75]

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[74] Securities Industry Study, supra note 62.

[75] Id. at 40.

1975 Amendments

The Securities Industry Study ultimately led to Congress enacting the Securities Act Amendments of 1975 ("1975 Amendments"),[76] which made sweeping changes to the federal securities laws, implemented many of the principal recommendations from the Securities Industry Study, and established both the national market system[77] and the National C&S System as they exist today.[78] In particular, in the new statute, Congress directed the Commission to, among other things: (i) "facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities;"[79] (ii) "end the physical movement of securities certificates in connection with the settlement among brokers and dealers of transactions in securities;"[80] and (iii) establish a system for reporting missing, lost, counterfeit, and stolen securities.[81]

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76 Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (1975). See also S. Rep. No. 75, at 7 (1975).

77 Section 11A of the Exchange Act directed the Commission to facilitate the establishment of a national market system to link together the multiple individual markets that trade securities and achieve the objectives of efficient, competitive, fair, and orderly markets, that are in the public interest, and protect investors. See Exchange Act Section 11A(a)(2), 15 U.S.C. 78k-1(a)(2).

78 See Exchange Act Section 17A(a)(2), 15 U.S.C. 78q-1(a)(2). For legislative history concerning Section 17A, see, e.g., S. Rep. No. 75, at 4 (1975); H.R. Rep. No. 229, at 102 (1975).

79 Exchange Act Section 17A(a)(2)(A)(1), 15 U.S.C. 78q-1(a)(2)(A)(1). For legislative history concerning Section 17A, see supra note 80.

80 Exchange Act Section 17A(e), 15 U.S.C. 78q-1(e).

81 Exchange Act Section 17(f)(1), 15 U.S.C. 78q(f)(1).

### 3. Advent of the Modern Clearance and Settlement System (1975-present)

Early Proliferation of Clearing Agencies

Between 1968 and 1975, in addition to CCS (now known as DTC), several other securities depositories were established, including by the Midwest Stock Exchange, Inc., the Pacific Stock Exchange, and TAD Depository Corporation. The number of shares evidenced by certificates immobilized in depositories increased between 1968 and 1976 from approximately 400 million to over 4 billion.[82] On November 3, 1975, pursuant to its new authority and directives under the 1975 Amendments, the Commission adopted Rule 17Ab2-1(c)(1) and Form CA-1 for the registration of clearing agencies, including central securities depositories.[83] Later in 1975, the Commission granted temporary registrations as clearing agencies to nine entities, that were either clearing corporations or securities depositories.[84] Shortly after NSCC was formed in 1977 through the merger of NCC and the clearing facilities of the NYSE and American Stock Exchange, NSCC also sought, and was granted, temporary registration as a clearing corporation. The Commission also granted temporary registrations as a clearing

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82 Final Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other than the Name of the Beneficial Owner of Such Securities 55 (Dec. 3, 1976) ("Final Street Name Study").

83 See Exchange Act Rule 17Ab2-1(c)(1), 17 CFR 240.17Ab2-1(c)(1); Exchange Act Form CA-1, 17 CFR 249b.200.

84 The nine entities granted temporary registrations as clearing agencies were: (i) DTC; (ii) Bradford Securities Processing Services; (iii) Stock Clearing Corporation of Philadelphia; (iv) Midwest Securities Trust Company; (v) Options Clearing Corporation; (vi) Midwest Clearing Corporation; (vii) Pacific Securities Depository Trust Company; (viii) Boston Stock Exchange Clearing Corporation; and (ix) TAD Depository.

corporation to the New England Securities Depository Trust Company and the Philadelphia Depository Trust Company in 1976 and 1979, respectively.[85]

Advances in Technology (1976-present)

Over the next several decades, factors such as technology enhancements and regulatory changes led to the increased prevalence of securities depositories, and many of them substantially expanded their services and participant base, especially DTC. Of particular note, in 1975, DTC introduced the Fast Automated Securities Transfer ("FAST") Program, which was approved by the Commission in 1976.[86] Among other things, it reduced the costs and risks associated with moving street name securities between DTC and participants.

Prior to FAST, transferring securities to or from DTC on behalf of its participants required moving certificated securities back and forth between DTC and transfer agents. For securities being deposited with DTC, participants would send certificates to DTC, which would then send the certificates to the transfer agent for re-registration into the name of DTC's partnership nominee, Cede & Co.,[87] before returning the reregistered certificates to DTC. For securities being withdrawn from DTC, DTC would send the certificates registered in the name of

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85 For more information regarding clearing agency registration standards and the history of those standards, see Regulation of Clearing Agencies, Exchange Act Release No. 16900 (June 17, 1980), 45 FR 41920 (June 23, 1980).

86 Securities Exchange Act Release No. 12353 (Apr. 20, 1976), 41 FR 17823 (Apr. 28, 1976) (File No. SR-DTC-76-3). The FAST Program was introduced in 1976 with ten transfer agents and 400 securities issues. See Securities Exchange Act Release No. 55816, 3 n.5 (May 25, 2007), 71 FR 30648 (June 1, 2007) (File No. SR-DTC-2006-16). By the end of 1984, 64 transfer agents held balance certificates valued at $580 billion in 11,442 securities issues. See The Depository Trust Company Annual Report 1984, at 16 ("DTC Annual Report").

87 The name Cede & Co. was drawn from the term "certificate depository" and it was formed as a partnership partly because it was considered simpler to effect a transfer of securities registered in the name of a partnership nominee than in the name of a corporation. For more information about Cede & Co., including regarding the terms of its partnership agreement, see S. Rep. No. 93-62 (1974) ("Disclosure of Corporate Ownership").

Cede & Co. to the transfer agent for re-registration into the name designated by the withdrawing participant, and the transfer agent then returned to DTC both the reregistered certificate (which DTC would then deliver to the withdrawing participant or other entity designated by the participant) and a separate certificate registered in the name of Cede & Co. representing the remainder of DTC's position.[88]

The FAST Program substantially reduced the movement of paper certificates by permitting transfer agents to become custodians for balance certificates registered in the name of Cede & Co. The balance certificate represents on the transfer agent's books the sum total of shares for that issue held by all of DTC's participants.[89] Participants maintain corresponding books representing their securityholder accounts held in street name. Then, when securities are deposited into or withdrawn from DTC, FAST transfer agents adjust the denomination of the balance certificates and electronically confirm the changes with DTC on a daily basis, with the corresponding participant accounts adjusted accordingly by DTC.[90]

In 1983, DTC adopted technological enhancements to its Participant Terminal System which allowed participants to automatically match book-entry receive notifications and facilitate redelivery to other participants.[91] DTC also partnered with NSCC to provide an Institutional

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88 Securities Exchange Act Release No. 60196 (June 30, 2009), 74 FR 33496 (July 13, 2009) (File No. SR-DTC-2006-16).

89 Id. at 2-3.

90 Id. For a description of early DTC rules relating to FAST, see Securities Exchange Act Release No. 13342 (Mar. 8, 1977) (File No. SR-DTC-76-3); Securities Exchange Act Release No. 14997 (July 26, 1978) (File No. SR-DTC-84-4); Securities Exchange Act Release No. 21401 (Oct. 16, 1984) (File No. SR-DTC-84-8; Securities Exchange Act Release No. 31941 (Mar. 3, 1993) (File No. SR-DTC-92-15); Securities Exchange Act Release No. 46956 (Dec. 6, 2002) (File No. SR-DTC-2002-15).

91 For discussion of "Dual Host PTS," see DTC Annual Report, supra note 86, at 24-5.

Delivery System which, through an interface with NSCC's continuous net settlement system ("CNS"), allowed brokers to net the often very large trades made for institutional customers instead of settling trade-for-trade at DTC. In 1996, the Direct Registration System ("DRS") was implemented, which allowed investors to hold uncertificated securities in registered form directly on the books of the issuer's transfer agent.[92] DRS also allowed investors to transfer the shares to and from a brokerage account through FAST when they choose to sell or transfer the stock.[93]

A number of legal and regulatory changes also led to increased participation at securities depositories among banks and broker-dealers. For example, in 1978, the UCC was revised to substitute the concept of delivery of securities specific to the physical delivery of certificated securities with the concept of "transfer" by book-entry on the books of a central depository.[94] As a result, the only book-entry transfers that qualified the transferee for protected purchaser rights under the UCC, as discussed above in Section II.A, were those made on the books of a clearing corporation.

In 1982 and 1983, the NASD and five stock exchanges, including the NYSE and American Stock Exchange, amended their rules to require their members to use a Commission-registered securities depository for the confirmation, affirmation and settlement of transactions in

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92 See, e.g., Securities Exchange Act Release No. 37931 (Nov. 7, 1996), 61 FR 58600 (Nov. 15, 1996) (File No. SR-DTC-96-15) (approving establishment of DRS). Prior to the advent of DRS, unless they were held on a transfer agent's books through a direct stock purchase plan or dividend reinvestment plan, book-entry shares generally could only be held by beneficial owners in street name through FAST. For more detail on DRS, see infra Section IV.C.2. See also infra note 144 (dividend reinvestment plan).

93 If the securityholder wants to sell the shares, they are transferred into a broker's account by means of an "Electronic Participant Instruction" through DTC's proprietary communication network, the Profile Modification System ("Profile"), through which the shares are re-registered in the name of Cede & Co. See Securities Exchange Act Release No. 60304 (June 30, 2009), 74 FR 33496 (July 13, 2009) (File No. SR-DTC-2009-11). For additional information, see infra note 309.

94 See U.C.C. 8-320.

depository eligible securities if the member provides its customer with delivery-versus-payment privileges.[95] Delivery versus payment privileges allow payments to be made prior to or simultaneously with delivery of the securities. Because customers typically wanted those privileges, the rules had the effect of requiring the use of a registered securities depository to clear and settle institutional trades. As a result, DTC participation soared. In 1995 and 1996, several exchanges adopted uniform depository eligibility requirements, paving the way for an industry standard for depository eligibility determinations.[96] Finally, 1997 revisions to UCC Article 8 modernized securities holding rules by allowing depositories to make eligible additional foreign securities that are held through foreign custodians as well as other financial instruments.[97] New York's adoption of these revisions enabled DTC to use foreign banks as custodians. This increased DTC's ability to maintain custody of securities abroad,[98] which resulted in additional foreign securities and other financial products and instruments becoming depository eligible.[99]

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95 Securities Exchange Act Release No. 25120 (Nov. 13, 1987), 52 FR 44506 (Nov. 19, 1987) (File No. SR-NYSE-87-04).

96 See, e.g., Securities Exchange Act Release No. 35798 (June 1, 1995), 60 FR 30909 (June 12, 1995) (File Nos. SR-Amex-95-17, SR-BSE-95-09, SR-CHX-95-12, SR-NASD-95-24, SR-NYSE-95-19, SR-PSE-95-14, SR-PHLX-95-34); Securities Exchange Act Release No. 36788 (Jan. 26, 1996), 61 FR 3741 (Feb. 1, 1996) (File No. SR-CBOE-95-62).

97 See, e.g., U.C.C. 8-102(a)(7), (9), (17), 501, 506.

98 See The Depository Trust Company 1998 Annual Report, available at http://www.sechistorical.org/collection/papers/1990/1998_0101_DTCAR_1.pdf.

99 For example, DTC was able to expand eligible issues to include State of Israel bonds and Bankers' Acceptances, short-term debt instruments that are guaranteed by commercial banks. See The Depository Trust Company 1997 Annual Report, available at http://www.sechistorical.org/collection/papers/1990/1997_0101_DTCAR.pdf.

Clearing Agency Consolidation (1980s-present)

Throughout the late 1980s and mid-1990s, DTC merged with or absorbed business from several other depositories, leading to its further growth. First, in April 1987, the Pacific Stock Exchange Board of Governors closed the Pacific Securities Depository Trust Company. Virtually all eligible securities in its custody were moved to DTC. Then, in 1995, DTC and NSCC worked together to absorb the business of Midwest Securities Trust Company and Midwest Clearing Corporation in light of the Chicago Stock Exchange's decision to exit the clearing and settlement business.

By the late 1990s, DTC had become the largest depository in the United States, and NSCC was the largest clearing agency.[100] On June 15, 1999, the Commission issued an order approving DTC's integration with NSCC.[101] The Commission's order authorized DTC and NSCC to restructure their boards of directors so that one board served both corporations.[102] The Depository Trust & Clearing Corporation ("DTCC"), a holding company, was subsequently formed with DTC and NSCC as its subsidiaries.

Today, DTC provides depository and book-entry settlement services for substantially all corporate and municipal debt, equity securities, asset-backed securities, and money market instruments available for trading in the United States.[103] It provides custody and asset services

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100 SEC Annual Report, 1997, tbl.3 (Clearing Agencies), at 179 and tbl.9 (Depositories), at 180.

101 Securities Exchange Act Release No. 41800 (Aug. 27, 1999), 64 FR 48694 (Sept. 7, 1999) (File No. SR-NSCC-99-10).

102 Id.

103 See DTCC: Settlement & Asset Services, available at http://www.dtcc.com/asset-services.aspx (last visited December 11, 2015). See also DTCC, Our Capabilities 17 (2014), available at http://www.dtcc.com/~/media/Files/Downloads/About/DTCC_Capabilities.pdf.

for securities valued at over $37 trillion.[104] Approximately 1.4 million settlement-related transactions, with a value of approximately $600 billion, are completed at DTC each day.[105] DTC provides three primary services: (i) custody services; (ii) asset services, such as dividend and interest payment, reorganizations, and proxy services; and (iii) settlement services (through its interface with NSCC), all of which help facilitate the National C&S System mandated by the 1975 Amendments.

## III. TRANSFER AGENT ROLE IN CLEARANCE AND SETTLEMENT PROCESSES

Because transfer agents operate within the National C&S System, it is important to understand that system, especially concerning the services transfer agents provide by maintaining accurate ownership records on behalf of issuers, facilitating the issuance or cancellation of securities, and distributing dividends within that system. Accordingly, this section provides a general overview of transfer agents' operations and processes within the National C&S System.

### A. Types of Security Ownership

Under the current centralized depository model in the United States, there are two types of securities owners: (a) registered and (b) beneficial.

#### *1. Registered Securityholders*

Under state corporation law, certain securityholder rights commonly accrue only to those registered on the securityholder list and not to persons who may have an ultimate economic interest in the shares but who are not registered securityholders.[106] Registered securityholders

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104 Id.

105 Id.

106 See, e.g., Del. Code Ann. tit. 8, § 219(c) (right to examine the stockholder list or to vote in person or by proxy at any meeting of stockholders limited to registered securityholders).

(who may also be referred to as "holders of record")[107] own and hold securities in "registered form."[108] The UCC provides that an "issuer...may treat the registered owner as the person exclusively entitled to vote, receive notifications, and otherwise exercise all the rights and powers of an owner."[109] Registered securityholders are listed directly on the records of the issuer or the issuer's transfer agent under their own names.[110] The issuer or its transfer agent may have direct contact with the registered securityholder, keep the records that reflect the ownership interest of the registered securityholder, and provide services directly to the registered securityholder. These services may include issuing, cancelling and transferring shares, making distributions, providing communications and mailings from the issuer, and answering securityholder inquiries. Registered owners can hold their securities either in certificated form or in uncertificated (i.e., book-entry) form, such as uncertificated securities held through DRS.[111]

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107 See Exchange Act Rule 17Ad-9(a)(3), 17 CFR 240.17Ad-9(a)(3) (referring to "securityholder's registration"); Exchange Act Rule17Ad-9(a)(4), 17 CFR 240.17Ad-9(a)(4) (referring to "registered securityholder"); Exchange Act Rule 12g5-1, 17 CFR 240.12g5-1 ("securities shall be deemed to be 'held of record' by each person who is identified as the owner of such securities on records of security holders maintained by or on behalf of the issuer").

108 See U.C.C. 8-102(a)(13). ("'Registered form,' as applied to a certificated security, means a form in which: (i) the security certificate specifies a person entitled to the security; and (ii) a transfer of the security may be registered upon books maintained for that purpose by or on behalf of the issuer, or the security certificate so states.")

109 U.C.C. 8-207.

110 Because a registered securityholder may be either a natural person or a legal entity, such as a partnership, trust, or corporation, transfer agents generally are familiar with issues that may arise with respect to a registered securityholder's legal status in connection with securities processing transactions. See Guttman, supra note 6, at § 5:19-5:28 (discussing different "aggregate" and corporate types of registered securityholders).

111 A registered securityholder's options for holding uncertificated securities, through DRS or otherwise, will be subject to the issuer's governing documents and the law of its jurisdiction of organization, as well as to other legal requirements that may apply to the issuer, such as rules of SROs such as DTC and national securities exchanges. For additional discussion of DRS, see supra note 92 and infra Section IV.

## 2. *Beneficial Owners*

The vast majority of securityholders in the U.S. are beneficial owners rather than registered owners.[112] Beneficial owners do not own the securities directly but generally have purchased them through an intermediary, such as a broker or a bank, and determined to hold them in street name through a book-entry account with that intermediary. The intermediary, rather than the transfer agent, maintains and updates the securityholder records, facilitates or executes transfers, and provides other services for the securityholder.[113]

When securities are held in street name, there is a legal distinction between the nominee, who has legal status as the registered securityholder, and the person with economic or beneficial ownership of the security.[114] Securities held in street name are legally owned by and registered in the name of the depository's nominee (most often DTC's nominee, Cede & Co.). The individual investor's broker (or other intermediary) who is a member or participant of the depository will be identified on the books of the depository as having a "securities entitlement"[115] to a pro rata share of the fungible bulk of that security held by the depository.[116]

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112 For more information regarding beneficial ownership, see, e.g., Final Street Name Study, supra note 82; Concept Release On The U.S. Proxy System, Exchange Act Release No. 62495 (July 14, 2010), 75 FR 42982 (July 22, 2010) ("Proxy Concept Release"); Holding Your Securities—Get the Facts, SEC, available at http://www.sec.gov/investor/pubs/holdsec.htm.

113 These transfer and recordkeeping services provided to beneficial owners by intermediaries may be referred to as "sub-transfer agent" services. For more information, see infra Section VII.B.

114 For additional detail concerning aspects of beneficial ownership, see Preliminary Street Name Study, supra note 45, at 9-11. For an example of reference in a rule of the Commission to "beneficial owner[s]," see, e.g., Exchange Act Rule 13d-3, 17 CFR 240.13d-3 (determination of beneficial owner).

115 See U.C.C. 8-102(a)(7) (defining "entitlement holder" as a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary); U.C.C 8-102(a)(17) (defining "security entitlement"); U.C.C. 8-102(a)(14) (defining "securities intermediary" as (i) a clearing corporation or (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity); U.C.C. 8-503(b) (providing that an

Correspondingly, the individual investor will be identified on the books of the depository participant (his or her broker or other intermediary) as having a securities entitlement to a pro rata share of the securities in which the participant has an interest. At each level, the intermediary will be obligated to provide the entitlement holder with payments and distributions with respect to the financial asset and to exercise rights as directed by the entitlement holder.[117] A securities intermediary satisfies such duties where the intermediary acts as required by any agreement between the intermediary and entitlement holder.[118] The entitlement holder will be permitted to look only to the intermediary for performance of the obligations.[119] Other rights and interests that a beneficial owner has against a securities intermediary's property are created by agreements between the beneficial owner and the securities intermediary.

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entitlement holder's property interest with respect to a particular financial asset under [U.C.C. 8-503(a)] is a pro rata property interest in all interests in that financial asset held by the securities intermediary).

116 For securities held in "fungible bulk," there are no specifically identifiable shares directly owned by DTC participants. Rather, each participant owns a pro rata interest in the aggregate number of shares of a particular issuer held at DTC. In turn, each customer, such as an individual investor of a DTC participant, owns a pro rata interest in the shares in which the DTC participant has an interest. See Processing of Tender Offers Within the National Clearance and Settlement System, Exchange Act Release No. 19678, n.5 (Apr. 15, 1983), 48 FR 17603, 17605, n.5 (Apr. 25, 1983) (describing fungible bulk) ("Rule 17Ad-14 Proposing Release"); Office of Investor Education and Advocacy, Investor Bulletin: DTC Chills and Freezes, SEC (May 2012), available at https://www.sec.gov/investor/alerts/dtcfreezes.pdf (discussing fungible bulk).

117 U.C.C. 8-505, 506.

118 U.C.C. 8-505(a)(1), 506(1). In the absence of an agreement covering payments and distributions, the securities intermediary must exercise due care in accordance with reasonable commercial standards. In the absence of an agreement with respect to the exercise of rights as directed by the entitlement holder, the securities intermediary either must place the entitlement holder in a position to exercise the rights directly or exercise due care in accordance with reasonable commercial standards to follow the direction of the entitlement holder. U.C.C. 8-505(a)(2), 506(2).

119 U.C.C. 8-503(c) (referring only to "securities intermediar[ies]" with respect to enforcement rights that may be exercised by an entitlement holder).

### B. Clearance and Settlement Process

The clearance and settlement process differs depending on the type of security being traded, how the security is held by the investor (i.e., registered or beneficial form), the market or exchange on which it is traded, and the specific entities and institutions involved. Yet, regardless of the specific variables involved, the basic clearance and settlement processes are substantially similar. For illustration purposes, this section describes generally the clearance and settlement process for exchange-based equity trades held in street name.

All securities trades involve a legally binding agreement that sets forth the terms of the trade. In general, the "clearing" of those trades is the process of comparing and confirming the material terms of the agreement: (i) the identity of the buyer and seller; (ii) the identity and quantity of the securities being traded; and (iii) the price, date, and other material details of the trade.[120] Clearing can be "bilateral," where the parties to the transaction work directly with each other to take the steps necessary to clear the transaction, or "central," where a third party, such as a clearing agency, undertakes the steps necessary to clear the transaction.[121]

Settlement is the fulfillment by the parties to the transaction of their respective obligations for the trade, usually by exchanging funds for the delivery of securities. For equities,

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120 October 1987 Market Break Report, supra note 54, at 10-2 through 10-5; Teweles, supra note 8, at 302-3.

121 Prior to the 1980s, central clearing predominantly involved a two-sided matching process conducted mainly by the exchanges, where an exchange collected trade data and passed that information to the clearing agency. After the October 1987 Market Break led to significant numbers of unmatched trades, the Commission recommended that automated systems should be used to facilitate comparison at or near the time of trade execution. See Securities and Exchange Commission Recommendations regarding the October 1987 Market Break, contained in Testimony delivered by David S. Ruder, Chairman, Securities and Exchange Commission, before the Senate Committee on Banking, Housing and Urban Affairs, p. 23 (Feb. 3, 1988). The recommendation was subsequently adopted in stages. See, e.g., New York Stock Exchange, Inc. "Overnight Trade Comparison," adopted Aug. 14, 1989, Exchange Act Release No. 27096 (Aug. 3, 1989), 54 FR 33299 (Aug. 14, 1989).

settlement generally occurs three business days after the trade date (i.e., "T+3"),[122] although other arrangements may be available by private agreement.[123] Delivery currently is far more likely to be by book-entry than by exchange of physical certificates. As previously discussed, the brokers' certificates in DTC's depository are held in fungible bulk and registered in the name of Cede & Co. to facilitate book-entry transactions involving electronic debits (on the seller's side) and credits (on the buyer's side) to the brokers' securities accounts at the depository rather than the movement of physical securities certificates. Because these shares are held in street name, DTC knows the names of the brokers who are DTC participants (often referred to as clearing brokers) but not the names of brokers who are not DTC participants (often referred to as introducing brokers) or either type of brokers' customers.[124] The brokers track the holdings of their customers who are the ultimate beneficial owners of the securities. For securities held in fungible bulk, rights are passed from record owner Cede & Co. through securities intermediaries to the ultimate beneficial owner.

Equity trades that are cleared and settled through DTC's facilities are generally processed in NSCC's CNS system, with final settlement on the third business day after the trade is executed. NSCC has approximately 1,000 members, made up of brokers, dealers, banks, and other intermediaries. Using CNS, NSCC nets multilaterally all of the clearing participants'

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122 See Exchange Act Rule 15c6-1, 17 CFR 240.15c6-1. T (or T+0) is the day the trade is executed. The first business day following the trade date is T+1, and so on. Thus, assuming there are no non-business days in the week, a trade that is executed on a Monday (T or T+0) would settle on Thursday (T+3). A trade executed on Friday would settle on the following Wednesday (Saturday and Sunday are not business days, so T+1 is Monday, T+2 is Tuesday, etc.).

123 See, e.g., NYSE Rule 64 (2009).

124 For further information on introducing and clearing brokers, see fig. 1 and accompanying text, infra.

purchases and sales in each security to one security position per participant per day in order to arrive at a daily net settlement obligation for each participant. NSCC then makes deliveries only on the remaining net positions through settlement accounts that the participants hold with DTC (for securities) and the Federal Reserve System (for cash).[125] Because NSCC interposes itself between trading brokers on each trade and guarantees the settlement as each broker's counterparty,[126] each broker's settlement is with NSCC and DTC, not with the other clearing participant, which reduces the brokers' exposure to risk of default by other brokers (i.e., counterparty risk). A broker can either settle each day or carry open commitments forward to net against the next business day's settlement (hence the continuous nature of CNS).[127] On the cash side of the trade, all money owed to or from a particular DTC participant will be netted down each day by NSCC to a single dollar amount, which reduces the amount of money firms need to have on hand to settle their obligations.

The goal of netting is to minimize the number and value of transactions required for buyers and sellers (or the firms acting on their behalf) to settle their transactions. For example, if a broker purchases 100 shares of XYZ stock for a customer and sold 50 shares of XYZ stock for another customer, at the end of the day the broker's securities account at DTC would be credited with 50 shares of XYZ (the net difference between buying 100 shares and selling 50 shares). If

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125 NSCC Rule 11, 68-74 (May 4, 2015), available at www.NSCC.com ("Continuous Net Settlement"). The Federal Reserve System refers to the central bank of the United States, and is commonly referred to as the "Federal Reserve." The Federal Reserve Board is the governing body for the Federal Reserve System. See generally, Federal Reserve, http://www.federalreserve.gov/aboutthefed/default.htm.

126 NSCC Rule 11,68-74 (May 4, 2015), available at www.dtcc.com; see also Becker and Etter, International Clearance and Settlement, 14 Brook. J. Int'l L. 275, note 15 (1988); David M. Weiss, After the Trade is Made – Processing Securities Transactions 245-49 (2006) ("After the Trade is Made").

127 See October 1987 Market Break Report, supra note 54, at ch. 10, 1-12; Tewěles, supra note 8, at 312-26.

the broker paid $25 per share to buy the 100 shares of XYZ and sold the 50 shares for the same price on the same day, at the end of the day the broker's cash account would be debited $1,250. The vast majority of equity trades handled by DTC clear and settle through NSCC's CNS, which, on average, results in an reduction of the volume of settlement transactions by approximately 98%.[128] As a result, on average, 99% of all trade obligations that occur in U.S. equity markets do not require the exchange of money.[129]

For illustration purposes only, Figure 1 below depicts one possible example of how an equity trade effected on a national securities exchange is cleared and settled, beginning with the buyer conveying an order to an executing broker. If the executing broker is a member of NSCC it may be referred to as a "clearing broker." If it is not a member of NSCC, it may be referred to as an "introducing broker" or "correspondent broker," depending on whether the broker carries and is responsible for the customer's account. Where the executing broker is a member of NSCC (i.e., a clearing broker) it routes the order for execution to a national securities exchange. Where the executing broker is not a member of NSCC (i.e., an introducing or correspondent broker) it routes the order to a clearing broker who will then route the order for execution to a national securities exchange. The national securities exchange matches the order with a corresponding sell order and then sends matched trade data to NSCC. NSCC nets these orders using its CNS system. If the securities are held in street name, there will be no change to the

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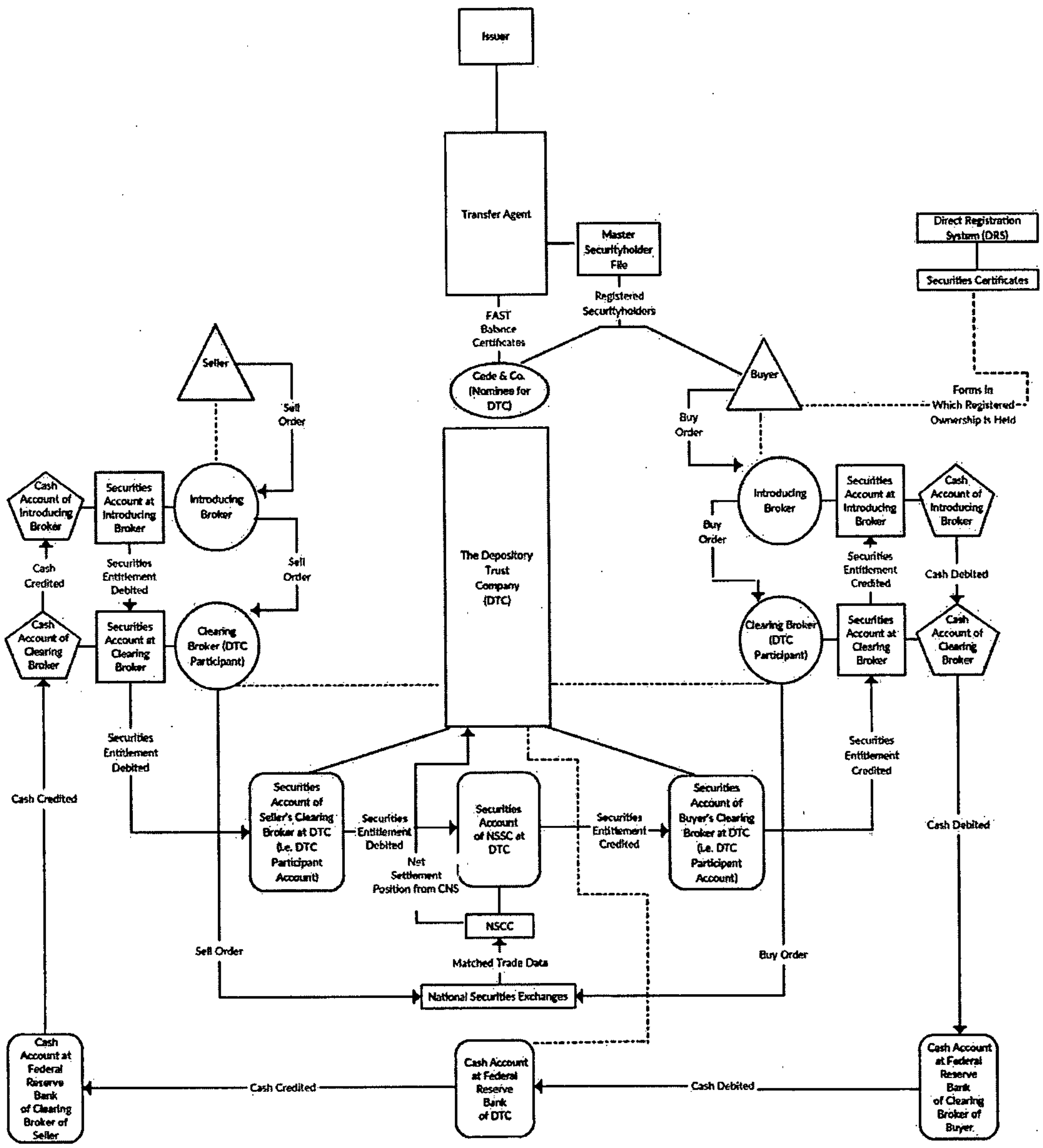
128 See DTCC's overview of NSCC, stating that NSCC's netting system results in "reducing the value of securities and payments that need to be exchanged by an average of 98% each day," available at http://www.dtcc.com/about/businesses-and-subsidiaries/nscc.

129 Virginia B. Morris and Stuart Z. Goldstein, Guide to Clearance and Settlement: An Introduction to DTCC, 8 (2009).

master securityholder file[130] maintained by the transfer agent and settlement will be effected by crediting and debiting the securities entitlement accounts of the buyer and seller, respectively. Thus, final settlement of the securities leg of the transaction will involve the following sequential steps: (i) the DTC securities account of the seller's clearing broker will be debited with the securities being purchased; (ii) NSCC's securities account at DTC will be credited with the securities purchased; (iii) the DTC securities account of the buyer's clearing broker will also be credited; and (iv) each broker will credit or debit their respective customers' securities accounts held with the broker. On the cash side, final settlement will involve the following sequential steps: (i) the Federal Reserve bank account of the buyer's clearing broker will be debited for the sale price of the securities; (ii) DTC's Federal Reserve bank account will credited for the sale price of the securities; (iii) DTC will transfer this cash to the Federal Reserve bank account of the seller's Clearing Broker; and (iv) each broker will credit or debit its respective customers' cash accounts held with the broker.

130 See infra Sections IV.A.3 and V.A. for additional description and discussion of transfer agents' role and responsibilities with respect to the master securityholder file.

Figure 1:




## IV. TRANSFER AGENT REGULATION: ORIGINS AND CURRENT STATUS

This section provides a general overview of the federal and state law and other requirements, such as those of self-regulatory organizations ("SRO"), that apply to transfer agents and their activities. We begin with a review and discussion of each of the Commission's current transfer agent rules, then briefly discuss banking regulations and taxation-related requirements that may apply to transfer agents.[131] We then review the requirements of SROs that apply to transfer agents, particularly DTC and NYSE rules. Finally, we discuss the regulation of transfer agents under state law. Later, in Sections V, VI, and VII of the release, we discuss issues and concerns related to modern transfer agent activities and seek comment on the best approach to addressing them.

### A. Federal Transfer Agent Rules

Prior to 1975, most transfer agents were banks or trusts.[132] There was no federal regulation of transfer agents and transfer agents were subject to state law, generally pursuant to UCC provisions.[133] Transfer agents were also subject to stock exchange requirements regarding securities processing. For example, in 1869, the NYSE adopted a requirement that all shares of NYSE-listed companies must be registered at a bank or other agency.[134] As another example, the "Chambers Street Rule" of the NYSE required transfer agents to maintain offices for transfer south of Chambers Street in New York City.[135] The American Stock Exchange had similar requirements in its Rule 891.[136]

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131 See Section IV.B, supra, for discussion of bank transfer agents. Transfer agents that are not banks may be referred to as non-bank transfer agents.

132 Unsafe Practices Study, supra note 17, at 38.

133 For a discussion of state law requirements impacting transfer agent processes, see supra Sections II and III.

134 See Facts and Figures, Historical, Chronology of New York Stock Exchange (1792-1929), available at http://www.nyxdata.com/nysedata/asp/factbook/viewer_edition.asp?mode=table&key=2169&category=4.

135 See Jerry W. Markham, A Financial History of the United States: From Christopher Columbus to the Robber Barons (1492-1900) 288 (2002).

136 See, e.g., Securities Exchange Act Release No. 37562 (Apr. 25, 1996), 61 FR 43283 (Aug. 13, 1996) (File No. SR-DTC-96-09) (mentioning American Stock Exchange Rule 891 requirements). These requirements were criticized by non-New York banks providing transfer agent services as many banks viewed providing

The 1975 Amendments gave the Commission regulatory authority for the first time over transfer agents.[137] Section 3(a)(25) of the Exchange Act defines a "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:

(A) countersigning such securities upon issuance;

(B) monitoring the issuance of such securities with a view to preventing unauthorized issuance (i.e., a registrar);[138]

(C) registering the transfer of such securities;

(D) exchanging or converting such securities; or

(E) transferring record ownership of securities by bookkeeping entry without the physical issuance of securities certificates.[139]

Section 17A(c)(1) of the Exchange Act requires any person performing any of these functions with respect to any security registered pursuant to Section 12 of the Exchange Act or with respect to any security which would be required to be registered except for the exemption contained in subsection (g)(2)(B) or (g)(2)(G) of Section 12 ("Qualifying Security") to register

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transfer agent services as an important part of providing the full-service relationship it was believed was desired by corporate borrower clients. See Charles Welles, The Great Paper Fight: Who Will Control the Machinery?, Institutional Investor (May 1973), Hearings on S.2058 before S. Comm. on Banking, Hous. and Urban Affairs, Subcomm. on Securities, 93rd Cong. 334 (1973). The NYSE amended the Chambers Street Rule in 1971, permitting out-of-town transfer agents to act as listed company transfer agents, subject to certain conditions including that they maintain a "drop" office in lower Manhattan. In 2005, the Commission issued an order that approved an NYSE rule change that eliminated the Chambers Street Rule. Securities Exchange Act Release No. 51973 (July 5, 2005), 70 FR 40094 (July 12, 2015) (File No. SR-NYSE-2004-62).

137 See S. Rep. No. 75, 57-58 (1975) (to accompany report S. 249). S. 249 is the principal legislative history of the Securities Acts Amendments of 1975 of which the transfer agent legislation was a part.

138 For additional information regarding "registrars," see supra note 51 and Sections II.B and II.C.1 and infra notes 298, 299, 320, 341 and Section IV.C.1.

139 Exchange Act Section 3(a)(25), 15 U.S.C. 78c(a)(25). Note that any insurance company or separate account which performs such functions solely with respect to variable annuity contracts or variable life policies which it issues or any registered clearing agency which performs such functions solely with respect to options contracts which it issues is excluded from the definition of "transfer agent" under the Exchange Act. Id.

with the Commission or other Appropriate Regulatory Agency ("ARA").[140] With respect to any transfer agent so registered, Section 17A(d)(1) of the Exchange Act authorizes the Commission to prescribe such rules and regulations as may be necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act.[141] Once a transfer agent is registered, either compulsorily or voluntarily,[142] the Commission "is empowered with broad rulemaking authority over *all* aspects of a transfer agent's activities as a transfer agent."[143]

Beginning in the late 1970s and early 1980s, the Commission adopted a series of transfer agent rules designed to regulate the basic recordkeeping and processing functions performed by transfer agents. The rules primarily related to routine transfers of certificated equity and debt securities and generally covered three areas: (i) registration and annual reporting requirements; (ii) timing and certain notice and reporting requirements related to securities transaction processing (referred to as "turnaround rules"); and (iii) recordkeeping and record retention rules and safeguarding requirements for securities and funds.

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140 Exchange Act Section 17A(c)(1), 15 U.S.C. 78q-1(c)(1). Additionally, see infra Section IV.B for discussion of bank ARAs.

141 As noted in the Committee Report which accompanied Section 17A(d)(1) of S.249, the precursor to Section 17A(d)(1) of the 1975 Amendments, Congress intended to ". . . empower[] [the Commission] with broad rulemaking authority over all aspects of a transfer agents' activities as transfer agent." Senate Report on Securities Act Amendments of 1975, supra note 44, at 57.

142 There is no statutory or other prohibition on voluntary registration as a transfer agent, although it is relatively uncommon. See generally, Exchange Act Section 17A(c), 15 U.S.C. 78q-1(c). See also infra Section VII.B.1, discussing the practice of voluntary registration as transfer agents by certain third party administrators ("TPA").

143 See Senate Report on Securities Act Amendments of 1975, supra note 44. The Committee Report elaborated that it expected the Commission's regulations "to include, among other matters, minimum standards of performance, the prompt and accurate processing of securities transactions, and operational compatibility of and cooperation by transfer agents with other facilities and participants in the securities handling process." Id.

As discussed more fully below, processing obligations related to mutual funds, dividend reinvestment plans ("DRIPs"),[144] and limited partnerships were expressly exempted from most of the processing and recordkeeping rules because at the time, the Commission believed that the activities required for the redemption of investment company shares and shares purchased or sold through a DRIP were significantly different from those required for the transfer of stocks and bonds.[145] Although the Commission has made modest revisions to the initial transfer agent rules and has added several new rules since the adoption of those earlier rules, the core registration, processing, recordkeeping, and safeguarding rules remain substantially unchanged, and the exemptions for mutual funds, DRIPs, and limited partnerships have not been revisited.

*1. Registration and Annual Reporting Requirements*

The rules setting forth the registration, annual reporting, and withdrawal requirements for transfer agents are found in Exchange Act Rules 17Ac2-1 (application for registration), 17Ac2-2 (annual reporting), and 17Ac3-1 (withdrawal from registration).

<u>Rule 17Ac2-1 and Form TA-1</u>

Before a transfer agent may perform any of the statutory transfer agent functions defined in Section 3(a)(25) of the Exchange Act for a Qualifying Security, it must apply for registration by submitting Form TA-1 (Uniform Form of Registration as a Transfer Agent and for Amendment to Registration) to its ARA and its registration as a transfer agent with its ARA must

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144 DRIPs allow investors who already own an issuer's stock to reinvest their cash dividends by purchasing additional shares or fractional shares directly from the issuer or the issuer's transfer agent, without going through a broker. Most DRIPs require the investor to become a registered securityholder, as opposed to a street name holder.

145 <u>See</u> Regulation of Transfer Agents, Exchange Act Release No. 13636 (June 16, 1977), 42 FR 32404, 32408 (June 24, 1977) ("Rule 17Ad-1 through 17Ad-7 Adopting Release").

have become effective.[146] Form TA-1 requires a transfer agent seeking to register to disclose information including the following: (a) general identification information[147] about the transfer agent and whether it is part of any service company arrangements;[148] (b) the identity of its direct and indirect owners and other control persons;[149] and (c) whether it or any of its control affiliates has been subject to investment-related criminal prosecutions, regulatory actions, or civil actions.[150] The registration automatically becomes effective 30 days after the Form TA-1 is filed, unless the ARA takes affirmative action to accelerate, deny, or postpone registration in accordance with the provisions of Section 17A(c) of the Exchange Act.[151] A registrant must amend its Form TA-1 within 60 days following the date on which information reported therein

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146 Exchange Act Section 17A(c)(1), 15 U.S.C. 78q-1(c)(1); 17 CFR 240.17Ac2-1; SEC Form TA-1, 17 CFR 249b.100. Once registration has become effective, a transfer agent may be subject to censure, suspension, limitation, or revocation of its registration if the transfer agent or any person associated with the transfer agent fails to obey Commission rules or violates certain of the securities laws. Exchange Act Section 17A(c)(3), 15 U.S.C. 78q-1(c)(3); Exchange Act Section 17A(c)(4)(C), 15 U.S.C. 78q-1(c)(4)(C).

147 SEC Form TA-1, Items 1-7 (concerning basic identification information (such as name, contact person, phone number, address and email address), identification numbers including the transfer agent's file number and FINS number, and information concerning service company arrangements in which the registrant may be involved). The file number for a transfer agent registered with the Commission would be the file number assigned by the Commission. A FINS number, short for Financial Industry Number Standard, is a unique five digit number issued by DTC and used by the securities industry as a means of identifying financial institutions in automated data processing systems. See Notice of Assumption or Termination of Transfer Agent Services, Exchange Act Release No. 35039 n.12 (Dec. 1, 1994), 59 FR 63656 (Dec. 8, 1994) ("Adopting Release for Rule 17Ad-16"); See Becoming a DTC-Eligible Agent, DTCC, http://www.dtcc.com/asset-services/agent-services/dtc-eligible-agent (information provided by DTCC, the parent company of DTC, including a form for authorizing DTC to issue a FINS number).

148 For definition of "service company," see infra note 241 and accompanying text.

149 SEC Form TA-1, Items 8 and 9, 17 CFR 249b.100.

150 SEC Form TA-1, Item 10, 17 CFR 249b.100.

151 Exchange Act Rule 17Ac2-1(a), 17 CFR 240.17Ac2-1(a); SEC Form TA-1, General Instruction G, 17 CFR 249b.100. Note that the 30-day time period in Exchange Act Rule 17Ac2-1(a), 17 CFR 240.17Ac2-1(a), is shorter than the Exchange Act's 45-day time period for applications to be effective. Exchange Act Section 17A(c)(2), 15 U.S.C. 78q-1(c)(2).

becomes inaccurate, incomplete, or misleading.[152] For transfer agents for whom the Commission is their ARA, they must file Form TA-1 and amendments thereto electronically on the Commission's EDGAR system and each answer provided by the transfer agent is required to be formatted as an XML data tag.[153]

Rule 17Ac2-2 and Form TA-2

All registered transfer agents, regardless of their ARA, must file an annual report with the Commission using Form TA-2 (Form for Reporting Activities of Transfer Agents Registered Pursuant to Section 17A of the Securities Exchange Act of 1934).[154] Form TA-2 covers a calendar year reporting period that ends on December 31[155] and must be filed by March 31 of the year following the end of the reporting period. Form TA-2 must be filed electronically on the Commission's EDGAR system and each answer provided by the transfer agent is required to be formatted as an XML data tag.[156]

Form TA-2 requires transfer agents to identify and report on the use of service companies, or other transfer agents, in connection with their transfer agent activities. It also requires transfer agents to provide annual data regarding the transfer agent's compliance with the

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152 Exchange Act Rule 17Ac2-1(c), 17 CFR 240.17Ac2-1(c); SEC Form TA-1, General Instruction H, 17 CFR 249b.100.

153 Exchange Act Rule 17Ac2-1(d), 17 CFR 240.17Ac2-1(d); Electronic Filing of Transfer Agent Forms, Exchange Act Release No. 54864, 5 (Dec. 4, 2006), 71 FR 74698 (Dec. 12, 2006) ("Electronic Filing of Transfer Agent Forms Release").

154 Exchange Act Rule 17Ac2-2(a), 17 CFR 240.17Ac2-2(a); SEC Form TA-2, 17 CFR 249b.102 (Form for Reporting Activities of Transfer Agents Registered Pursuant to Section 17A of the Securities Exchange Act of 1934).

155 Exchange Act Rule 17Ac-2-2(b), 17 CFR 240.17Ac2-2(b).

156 Exchange Act Rule 17Ac2-2(c), 17 CFR 240.17Ac2-2(c); Electronic Filing of Transfer Agent Forms Release, supra note 153, at 5.

turnaround rules. Additionally, the form requires transfer agents to provide the Commission with updated information about their business activities, including accounts administered, items received,[157] turnaround performance, total amounts of funds distributed, and lost securityholder accounts.[158]

Rule 17Ac2-2 provides exemptions from completing certain sections of Form TA-2 for small transfer agents and for transfer agents that outsource their work completely to service companies. If a registered transfer agent received fewer than 1,000 items for transfer in the reporting period and did not maintain master securityholder files for more than 1,000 individual securityholder accounts as of December 31 of the reporting period, it is only required to complete Questions 1 through 5, 11, and the signature section of Form TA-2.[159] A named transfer agent that engaged a service company to perform all of its transfer agent functions during the reporting period is only required to complete Questions 1 through 3 and the signature section of Form TA-2.[160]

The Commission, other ARAs and members of the public (including issuers and investors) use information on Forms TA-1 and TA-2. The Commission's EDGAR database provides a means through which information on these forms can be searched and retrieved. The Commission uses the information on Form TA-1 to review an entity's application for registration as a transfer agent and to maintain current information about transfer agents. The Commission

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157 See generally, Section IV.A.2 for discussion of "item."

158 See generally, SEC Form TA-2, 17 CFR 249b.102.

159 Exchange Act Rule 17Ac2-2(a)(1), 17 CFR 240.17Ac2-2(a)(1).

160 Exchange Act Rule 17 Ac2-2(a)(2), 17 CFR 240.17Ac2-2(a)(2).

uses information on Form TA-2, as well as information on Form TA-1 and amendments thereto, for several purposes, including: (i) to determine the nature of the business conducted by a transfer agent, (ii) to monitor transfer agent activities and to evaluate compliance with Commission rules, and (iii) to inform Commission transfer agent policymaking.[161] In connection with monitoring of and checking regulatory compliance by transfer agents, the Commission's examination and inspections program may use the information on Forms TA-1 and TA-2 to plan their site visits in connection with an exam. The examination staff of the Commission may also use the information on Forms TA-1 and TA-2 to identify particular issues to focus on during an exam or to analyze industry trends and to provide basic census information concerning registered transfer agents. In addition, Form TA-1 and TA-2 data provide the Commission with information about securities processing issues that may need to be addressed by Commission rulemaking. Form TA-1 and TA-2 data is also used by the Commission to assist it in evaluating the costs and benefits of potential rulemaking.

Rule 17Ac3-1 and Form TA-W

Pursuant to Rule 17Ac3-1, a registered transfer agent may voluntarily withdraw its registration by filing Form TA-W (Notice of Withdrawal from Registration as a Transfer Agent) with the relevant ARA, disclosing, among other things, any actual or potential claims or legal proceedings against the transfer agent, its reasons for withdrawing or ceasing to function as a transfer agent, and whether one or more successor transfer agents will take over the maintenance

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161 See Adoption of Revised Transfer Agent Forms and Related Rules, Exchange Act Release No. 23084 (Mar. 27, 1986), 51 FR 12124 (Apr. 9, 1986) ("Revised Transfer Agent Forms and Related Rules"); Electronic Filing of Transfer Agent Forms Release, supra note 153, at 5.

of its transfer books.[162] Withdrawal from registration automatically becomes effective 60 days after filing Form TA-W, unless the Commission or applicable ARA finds it in the public interest to take affirmative action to accelerate, deny, or postpone the request.[163]

### 2. *Processing, Reporting, Recordkeeping, and Exemptions: Rules 17Ad-1 Through 17Ad-7 and Rules 17f-1 and 17f-2*

On June 16, 1977, the Commission adopted Rules 17Ad-1 through 17Ad-7 as a set of performance standards for transfer agents.[164] These turnaround and processing rules were "designed to protect investors . . . and to contribute to the establishment of the national system for the prompt and accurate clearance and settlement of transactions in securities by," among other things, "assuring that the transfer agent community performs its functions in a prompt, accurate and more predictable manner." The rules primarily focused on establishing minimum performance and recordkeeping standards for routine transfers of certificated equity and debt securities and the prompt and accurate cancellation and issuance of certificated securities.[165] The rules were also designed to provide an early warning system to alert issuers and regulatory agencies when the performance standards are not being met, prohibit under-performing transfer agents from expanding their operations, require transfer agents to respond promptly to certain written inquiries regarding items presented for transfer, and require the maintenance and preservation of certain records necessary for regulatory authorities to monitor and enforce

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162 Exchange Act Rule 17 Ac3-1, 17 CFR 240.17Ac3-1; Exchange Act Section 17A(c)(3)(a), 15 U.S.C. 78q-1(c)(3)(A); SEC Form TA-W, 17 CFR 249b.101 (Notice of Withdrawal from Registration as a Transfer Agent).

163 Exchange Act Rule 17Ac3-1(b), 17 CFR 240.17Ac3-1(b).

164 Exchange Act Rules 17Ad1-7, 17 CFR 240.17Ad-1-7.

165 See Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at 32404.

transfer agent compliance with the turnaround rules.[166] The specific processing, reporting, and retention requirements were metrics-based and, at the time, considered to be those necessary to ensure that transfer agents adequately performed their functions and that the Commission and other ARAs would be able to monitor transfer agents' compliance with the turnaround rules.[167] Further, the new transfer agent rules established by the Commission were designed not only to ensure that transfer agents meet prescribed performance standards for their core recordkeeping and transfer activities, but to ensure they would be regulated appropriately in the context of the National C&S System and that any problems meeting these performance standards would not negatively impact individual investors or the clearance and settlement system as a whole.[168] Each rule is discussed in detail below.

Rule 17Ad-1 defines the relevant terms used throughout the rules. One of the most important is "item," which is defined as the certificates of a single issue of securities presented under one ticket,[169] and is the basic unit for which the turnaround and other processing requirements apply.[170] The other key definitions in Rule 17Ad-1 are "transfer" and "turnaround." "Transfer" of a certificated security (where an outside registrar is not involved) is the completion of all acts necessary to cancel the certificate, issue a new one, and make it

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166 Id. See also Exchange Act Rules 17Ad-1-7, 17 CFR 240.17Ad-1-7.

167 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at 32410.

168 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at 32407 (noting the importance of avoiding impediments to "the Commission's efforts to provide necessary or appropriate regulations for transfer agents in the broader context of the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions.").

169 Exchange Act Rule 17Ad-1(a)(1), 17 CFR 240.17Ad-1(a)(1) (definition of "item"). See supra note 17 (describing tickets).

170 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at 32404.

available to the presentor, and "turnaround" for an item (where an outside registrar is not involved) is completed when transfer is accomplished.[171]

Rule 17Ad-2 sets the basic performance standards for transfer agents.[172] Transfer agents who are not acting as a registrar must turnaround within three business days of receipt at least 90% of all "routine items"[173] received by the transfer agent during any month.[174] Non-routine items must receive "diligent and continuous attention" and must be "turned around as soon as possible."[175] Routine items that are not turned around within three business days nevertheless must be "turned around promptly."[176] Registered transfer agents acting as a registrar must "process" at least 90% of all items received during any given month no later than noon of the next business day for any item received after noon and no later than the opening of business on the next business day for those items received at or before noon.[177] If a transfer agent fails to meet the performance standards for turnaround set forth in Rule 17Ad-2 with respect to any month, it must notify the Commission and the transfer agent's ARA if it is not the Commission

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171 Exchange Act Rule 17Ad-1(d), (e), 17 CFR 240.17Ad-1(d), (e).

172 As discussed in more detail infra in Section IV.C.1, the NYSE imposes a 48 hour turnaround requirement.

173 Routine items are defined by Rule 17Ad-1(i), 17 CFR 240.17Ad-1(i). They are generally defined in the negative such that most items are considered routine so long as they do not require the requisition of a new certificate that the transfer agent does not have on hand, are not subject to a stop order, adverse claim, or other restriction on transfer, do not require certain additional documentation or review to complete the transfer, do not involve a transfer in connection with certain types of corporate actions, do not include a security of an issue which within the previous 15 business days was offered to the public pursuant to a Securities Act registration statement in an offering of a non-continuing nature, and do not include a warrant, right or convertible security either presented for transfer within five business days before rights expire or change or presented for exercise or conversion.

174 Exchange Act Rule 17Ad-2(a), 17 CFR 240.17Ad-2(a). We note that with automation, these standards are substantially easier to meet than when the rule was adopted in 1977.

175 Exchange Act Rule 17Ad-2(e), 17 CFR 240.17Ad-2(e).

176 Id.

177 Exchange Act Rule 17Ad-2(e), 17 CFR 240.17Ad-2(b).

within 10 business days of the end of the month, provide certain turnaround data regarding specific numbers and percentages of items, explain the reasons for the failure, identify what steps have been taken to prevent future failures, and provide certain data regarding routine items that have not been turned around and have been in the transfer agent's possession for "more than four business days."[178] Similar notification requirements apply where a transfer agent acting as a registrar fails to meet the processing performance standards.[179]

Rule 17Ad-3 provides limitations on the expansion of transfer agent activities if a transfer agent is unable to meet the minimum performance standards established by Rule 17Ad-2. Any transfer agent that is required pursuant to Rule 17Ad-2 to provide notice for failure to meet the performance standards for three consecutive months is prohibited from taking on new issues or providing new services for existing issues.[180] Further, if a transfer agent fails to turnaround or process at least 75% of all routine items, it must notify the chief executive officer of each issuer for which the transfer agent acts.[181] Thus, Rules 17Ad-2 and 17Ad-3, taken together, provide an early warning system to alert issuers, the Commission and other ARAs of untimely performance and potential problems.

Rule 17Ad-4 provides certain exemptions from the turnaround, processing, and recordkeeping rules.[182] Rule 17Ad-4(a) creates an exemption from Rules 17Ad-2, 17Ad-3, and

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178 Exchange Act Rule 17Ad-2(c), 17 CFR 240.17Ad-2(c).

179 Exchange Act Rule 17Ad-2(d), 17 CFR 240.17Ad-2(d).

180 Exchange Act Rule 17Ad-3(a), 17 CFR 240.17Ad-3(a). Such limitations on the business of the transfer agent continue until there has been a period of three successive months in which no notices have been required.

181 Exchange Act Rule 17Ad-3(b), 17 CFR 240.17Ad-3(b).

182 Exchange Act Rule 17Ad-4, 17 CFR 240.17Ad-4.

17Ad-6(a)(1)-(7) for the processing of interests in limited partnerships, DRIPs, and redeemable securities issued by investment companies registered under Section 8 of the Investment Company Act of 1940 ("Investment Company Act"), which are also known as open-end funds.[183] In 1977, the rationale for providing the exemption for interests in limited partnerships was "the low volume of transfers of such interests,"[184] while the rationale for providing the exemption for DRIPs was the Commission's view at the time that transfer agents' processing for DRIPs "require[s] procedures significantly different from the procedures required to transfer ownership of stocks and bonds."[185]

The Commission expressed the same rationale with respect to redeemable securities of registered investment companies, stating that transactions in these securities were "significantly different from the transfer of ownership of stocks and bonds on issuer's records."[186] In addition, the Commission noted that such activity "is subject to Section 22(e) of the Investment Company

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183 Investment Company Act Section 8, 15 U.S.C. 80a-8. See generally, Section VII.C for discussion of transfer agents for investment companies and the handling of redeemable securities issued by investment companies.

184 Regulation of Transfer Agents, Exchange Act Release No. 13293 (Feb. 24, 1977) ("Rule 17Ad-1 through 17Ad-7 Re-Proposing Release") ("From the information provided in SEC Form TA-1, 17 CFR 249b.100, the low volume of transfers of such [limited partnership] interests suggests that they may appropriately be exempted from revised [Rules 17Ad-2, 17Ad-3, and 17Ad-6(a)(1) through (a)(7)].").

185 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 45 ("Lastly, the exemptions of paragraph 17Ad-4(a) have been expanded to include the transfers and withdrawals of shares from dividend reinvestment plans which...require procedures significantly different from the procedures required to transfer ownership of stocks and bonds.")

186 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at n.13. As originally proposed, the exemption would have been for "securities of open-end investment companies," rather than "redeemable securities of investment companies." See Rule 17Ad-1 through 17Ad-7 Re-Proposing Release, supra note 184. By adding the word "redeemable," redeemable securities of registered unit investment trusts ("UIT") were included within the exemption. However, because closed-end investment companies do not issue redeemable securities, transfer agents servicing closed-end fund securities are not within the exemption. Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at n.14 ("The turnaround rules do apply to registered transfer agents performing transfer agent functions for securities issued by closed-end investment companies.") (emphasis added).

Act of 1940, 15 U.S.C. 80a-22(e),"[187] and that "[t]he amount of certificated fund shares is relatively small, and the amount of transfer agent activity in connection with transferring ownership of certificated shares represents a very small part of a transfer agent's activity with regard to an open-end investment company."[188] For these reasons, the Commission believed at the time that "it would be desirable to study further the need for, and the nature of, minimum performance standards for the transfer of securities effected by open-end investment companies registered under Section 8 of the Investment Company Act, 15 U.S.C. 80a-8."[189]

Rule 17Ad-4(b) provides a similar exemption for certain small transfer agents by exempting a registered transfer agent from the turnaround, processing, recordkeeping, and other provisions of Rules 17Ad-2(a), (b), (c), (d) and (h), 17Ad-3, and 17Ad-6(a)(2)-(7) and (11), provided the transfer agent has received fewer than 500 items for transfer and fewer than 500 items for processing within a consecutive six month period, and provided that the transfer agent has filed proper notice of its exempt status with its ARA or has prepared a document certifying that the transfer agent qualifies as exempt (with respect to those ARAs where filing is not required).[190] The rationale behind this exemption was that, because the number of transfers performed by these smaller transfer agents was relatively small and involved issues which are not traded actively, it was not necessary or appropriate at that time to require those smaller

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187 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at 32408.

188 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at n.13.

189 Rule 17Ad-1 through 17Ad-7 Re-Proposing Release, supra note 184.

190 The filing of notices of exempt status for these small transfer agents is required where the ARA is the Federal Deposit Insurance Corporation ("FDIC") or the Federal Reserve. Where the ARA is the Commission or the Office of the Comptroller of the Currency, the exempt transfer agent is not required to file a notice but must prepare a document certifying that the transfer agent qualifies as exempt and retain it in its records. See Exchange Act Rule 17Ad-4(b)(3), 17 CFR 240.17Ad-4(b)(3).

transfer agents to comply with the minimum performance standards, recordkeeping provisions, and other requirements in those rules.[191]

Rule 17Ad-5 generally requires a registered transfer agent to respond within prescribed timeframes to certain types of written inquiries.[192] Rule 17Ad-5(a) requires a registered transfer agent to respond within five business days following the receipt of an inquiry from any "person" concerning the status of an item presented for transfer by such person or their agent during the preceding six months, provided the inquirer provides specific information concerning the item.[193] Rule 17Ad-5(b) requires a registered transfer agent to respond to any "broker-dealer" inquiry within five business days confirming or denying whether it has possession of a security presented for transfer and, if it has possession, acknowledging the transfer instructions or revalidating the window ticket,[194] provided the broker-dealer provides certain identifying information.[195] Rule 17Ad-5(c) requires a registered transfer agent to respond within 10 business days confirming or denying possession of a security where any person or their agent has requested that the transfer agent confirm possession as of a given date of a certificate presented by such person during the preceding 30 days[196] and provides information similar to that which is required under Rules

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191 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at 32408.

192 Exchange Act Rule 17Ad-5, 17 CFR 240.17Ad-5. The response must generally be in writing, however, Rule 17Ad-5(f)(1) permits a telephone response if (i) the telephone response resolves the inquiry and (ii) the inquirer does not request a written response. Exchange Act Rule 17Ad-5(f)(1), 17 CFR 240.17Ad-5(f)(1).

193 Exchange Act Rule 17Ad-5(a), 17 CFR 240.17Ad-5(a) (requiring inquirer to provide: (i) the issue, (ii) the number of shares or units (or principal amount of debt securities), (iii) the approximate date of presentation, and (iv) the name in which the item is registered).

194 Exchange Act Rule 17Ad-5(b), 17 CFR 240.17Ad-5(b).

195 Id. See also supra note 193 (concerning information to be provided by inquirers).

196 Exchange Act Rule 17Ad-5(c), 17 CFR 240.17Ad-5(c).

17Ad-5(a) and (b).[197] If required by the transfer agent, the inquirer must also provide assurance of payment.[198] Rule 17Ad-5(d) requires a registered transfer agent to respond within 20 business days where any person requests a transcript of such person's account with respect to a particular securities issue as of a certain date not more than six months prior to the request.[199] If required by the transfer agent, the inquirer must provide the transfer agent assurance of payment of a reasonable fee for this service.[200]

Rules 17Ad-6 and 17Ad-7, taken together, address some of the basic aspects of the records that transfer agents must maintain and for how long.[201] Rule 17Ad-6 generally details what records every registered transfer agent shall make and keep. Rule 17Ad-6(a)(1) requires every registered transfer to make and keep receipts, tickets, logs, schedules, journals, and other records showing the number of routine and non-routine items received and made available each business day.[202] Rules 17Ad-6(a)(2) through (4) require maintenance of records that generally relate to the monitoring of performance standards for turnaround and for processing under Rule 17Ad-2 for each month and notices required to be filed under Rule 17Ad-2[203] and any written inquiries or requests, including those inquiries to transfer agents where the inquiries were not subject to Rule 17Ad-5 or inquiries which were answered orally or where no response was made. Rule 17Ad-6(a)(8) requires maintenance of any contracts and certain related documentation

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197 Id. See also supra note 193 (concerning information to be provided by inquirers).

198 Id.

199 Exchange Act Rule 17Ad-5(d), 17 CFR 240.17Ad-5(d).

200 Id.

201 Exchange Act Rule 17Ad-6, 17 CFR 240.17Ad-6.

202 Exchange Act Rule 17Ad-6(a)(1), 17 CFR 240.17Ad-6(a)(1).

203 Exchange Act Rule 17Ad-6(a)(2)-(4), 17 CFR 240.17Ad-6(a)(2)-(4).

showing the appointment or termination of the registered transfer agent to serve in any capacity on behalf of an issuer.[204] Rule 17Ad-6(a)(9) requires records of: (i) currently active stop orders;[205] (ii) adverse claims;[206] and (iii) restrictions on transfer.[207]

Rule 17Ad-7 specifies the particular lengths of time for which the various records described in Rule 17Ad-6 shall be maintained.[208] While the records listed in Paragraph (a)(1) of this rule were generally, at the time of its adoption in 1977, paper records such as receipts, tickets, schedules, they now are likely to be electronic records. Rule 17Ad-7(f), was updated in 2001 and 2003 to authorize the use of electronic recordkeeping, electronic storage media, and micrographic storage media, such as microfilm records.[209] Paragraph (g) of Rule 17Ad-7 regulates transfer agent records maintained by an outside service bureau, other recordkeeping service or the issuer."[210] Paragraph (h) states that when a registered transfer agent ceases to perform transfer agent functions, its responsibilities under this provision "shall end upon the

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204 Exchange Act Rule 17Ad-6(a)(8), 17 CFR 240.17Ad-6(a)(8).

205 For discussion of stop orders as a general matter, see supra notes 25 and 26.

206 For discussion of an adverse claim in connection with protected purchaser status under the UCC, see supra note 14 and accompanying text. Regarding the existence of an adverse claim as a factor resulting in classification of an item as non-routine under the Commission's transfer agent rules, see supra note 173, Exchange Act Rule 17Ad-1(i), 17 CFR 240.17Ad-1(i).

207 For discussion of securities subject to restrictions on transfer and of restrictive legends, see infra Section VI.D.

208 Exchange Act Rule 17Ad-7, 17 CFR 240.17Ad-7.

209 See Recordkeeping Requirements for Transfer Agents, Exchange Act Release No. 44227 (Apr. 27, 2001), 66 FR 21659 (May 1, 2001); Recordkeeping Requirements for Registered Transfer Agents, Exchange Act Release No. 48949 (Dec. 18, 2003), 68 FR 75050 (Dec. 29, 2003) ("Recordkeeping Requirements for Transfer Agents").

210 Exchange Act Rule 17Ad-7(g), 17 CFR 240.17Ad-7(g).

delivery of such records to the successor transfer agent," a provision that was originally included to clarify when a transfer agent is relieved of such recordkeeping responsibilities.[211]

Rule 17f-1[212] was adopted in 1976 pursuant to Section 17(f)(1) of the Exchange Act in order to curtail trafficking in lost, stolen, missing, and counterfeit securities certificates.[213] It requires reporting institutions, which are defined as national securities exchanges, brokers, dealers, registered transfer agents, and others, to report missing, lost, counterfeit, or stolen securities to the Commission or its designee. This led to the Commission's implementation in 1977 of the Lost and Stolen Securities Program and also led to subsequent Commission releases addressing in detail the structure of the program.[214] The program became fully operational on January 2, 1978 and consists mainly of an electronic database for securities certificates that have been reported lost, stolen, missing, or counterfeit.[215] The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") expanded Section 17(f)(1)'s statutory

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211 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at 32411.

212 Exchange Act Section 17(f)(1), 15 U.S.C. 78q(f)(1); Exchange Act Rule 17f-1, 17 CFR 240.17f-1. See also Adoption of Reporting and Inquiry Requirements with Respect to Missing, Lost, Stolen and Counterfeit Securities, Exchange Act Release No. 13053 (Dec. 15, 1976), 41 FR 54923 (Dec. 16, 1976) (order adopting Rule 17f-1).

213 See Senate Report on Securities Act Amendments of 1975, supra note 44 at 103-4; see also Hearings before the Permanent Subcomm. on Investigations of the S. Comm. on Gov't Operations, 93rd Cong., 1st Sess. (1973), 2nd Sess. (1974).

214 See, e.g., Implementation of program for reporting and inquiry with respect to missing, lost counterfeit or stolen securities, Exchange Act Release No. 13832 (Aug. 5, 1977), 42 FR 41022 (Aug. 12, 1977) (order adopting Release implementing the Lost and Stolen Securities Program); U.C.C. 8-405 ("Replacement of Lost, Destroyed, or Wrongfully Taken Security Certificate").

215 See supra note 25. Lost and Stolen Securities Program Amendments, Exchange Act Release No. 15867 (May 23, 1979), 44 FR 31500 (May 31, 1979).

coverage to add securities certificates that are cancelled to the categories that must be reported to the Commission or its designee.[216]

Rule 17f-2 was adopted in 1976 and requires the fingerprinting of certain securities industry personnel.[217] In accordance with its governing statute, Section 17(f)(2) of the Exchange Act,[218] Rule 17f-2 requires, with certain exemptions, the fingerprinting of all partners, directors, officers, and employees of brokers, dealers, registered transfer agents, and registered clearing agencies. The Dodd-Frank Act expanded Section 17(f)(2)'s statutory coverage to include the personnel of national securities exchanges, national securities associations, and registered securities information processors.[219]

### 3. *Recordkeeping and Safeguarding Rules: Rules 17Ad-8 through 17Ad-13*

The new regulatory regime established by the turnaround rules provided the Commission with visibility into the transfer agent industry and a way to review and analyze it. The first six years of monitoring transfer agent performance under the new regulatory regime highlighted some of the significant adverse operational and financial consequences for the securities industry, securities markets, issuer community, and investing public that could occur when a transfer agent's operations collapse, when records maintained by a transfer agent contain significant inaccuracies, or when a transfer agent's internal accounting controls are

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216 Pub. L. No. 111-203, 124 Stat. 1376, § 929D (2010).

217 Exchange Act Rule 17f-2, 17 CFR 240.17f-2; Lost and Stolen Securities Program Amendments, Exchange Act Release No. 12214 (Mar. 16, 1976), 41 FR 13594 (Mar. 31, 1976) (order adopting Rule 17f-2).

218 Exchange Act Rule 17(f)(2), 15 U.S.C.78q(f)(2).

219 Pub. L. No. 111-203, 124 Stat. 1376, § 929S.

inadequate.[220] The Commission therefore determined that additional rulemaking was necessary and appropriate to supplement the turnaround rules.

The impetus for Rule 17Ad-8 was the recommendation in the Final Street Name Study that "each depository be required to transmit periodically to each issuer whose securities the depository holds of record a list of the persons on whose behalf the depository holds the securities."[221] The rule, which was adopted in 1980, requires every registered clearing agency to provide promptly to each issuer or transfer agent acting on its behalf, upon request, a securities position listing which identifies the participants on whose behalf the clearing agency holds the issuer's securities in the name of the clearing agency or its nominee and the respective positions in such securities as of a specified date.[222] The clearing agency may charge issuers who request this service with fees designed to recover its reasonable costs.[223]

On June 10, 1983, the Commission adopted Rules 17Ad-9 through 17Ad-13.[224] These new rules established various requirements and exemptions designed to ensure that transfer agents maintain appropriate internal controls, meet adequate levels of service and performance, and avoid adverse operational and financial problems that could harm investors, issuers, or other securities industry participants. Most notably, the new rules established additional minimum

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220 See 17Ad-9 through 13 Proposing Release, supra note 2. In its release proposing Rules 17Ad-9 to 17Ad-13, the Commission cited examples of substandard transfer agent performance in the areas of recordkeeping and safeguarding and noted the significant adverse operational and financial problems caused by poor transfer agent performance or operations.

221 Securities Position Listing Rule, Exchange Act Release No. 16443 (Dec. 20, 1979), 44 FR 76774, 76775 (Dec. 28, 1979) ("Adopting Release for Rule 17Ad-8"); Final Street Name Study, supra note 82, at 55.

222 See Exchange Act Rule 17Ad-8, 17 CFR 240.17Ad-8; Adopting Release for Rule 17Ad-8, supra note 221.

223 Exchange Act Rule 17Ad-8(b), 17 CFR 240.17Ad-8(b).

224 Exchange Act Rules 17Ad-9-13, 17 CFR 240.17Ad-9-13

standards for recordkeeping and codified minimum requirements for the safeguarding of funds and securities.[225] The Commission believed that these additional minimum standards were critical to addressing seriously deficient transfer agent performance.[226]

Rule 17Ad-9[227] defines 12 principal terms with respect to transfer agents as used especially in Rules 17Ad-10 through 17Ad-13, consisting of the terms "certificate detail," "master securityholder file," "subsidiary file," "control book," "credit," "debit," "record difference," "record keeping transfer agent," "co-transfer agent," "named transfer agent," "service company transfer agent," and "file."[228]

Rule 17Ad-9's certificate detail,[229] with respect to certificated securities, includes, at a minimum, all of the following (and with respect to uncertificated securities, includes only items (ii) through (viii)): (i) the certificate number, meaning the unique serial number of each certificate of an issue of securities, as distinct from the CUSIP number[230] which is the same number for all certificates of the same issue; (ii) the number of shares (for equity securities) or principal dollar amount (for debt securities) designated by the certificate; (iii) the securityholder's registration, which is the name of the individual, partnership, or corporation in

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225 See 17Ad-9 through 13 Proposing Release, supra note 2.

226 Id. The Commission was particularly concerned with reducing the potential for transfer agent failure, which inevitably imposes substantial potential liabilities and costs on issuers, securities firms, and securityholders, as well as improving generally transfer agent performance, thereby reducing the broker-dealers' costs associated with fails to settle and extended transfer delays.

227 Exchange Act Rule 17Ad-9, 17 CFR 240.17Ad-9.

228 See 17Ad-9 through 13 Proposing Release, supra note 2.

229 For "certificate detail," see also Exchange Act Rule 17f-1(c)(6), 17 CFR 240.17f-1(c)(6).

230 CUSIP stands for Committee on Uniform Security Identification Procedures. A CUSIP number is assigned to most financial instruments. See CUSIP Number, SEC, http://www.sec.gov/answers/cusip.htm.

which a securities certificate is held and which registration appears on the face of the certificate; (iv) the address of the registered owner, which also appears on the face of the certificate; (v) the date the certificate was issued, which likewise appears on the face of the certificate; (vi) the "cancellation date of the securities certificate," which, if and when the certificate is cancelled will appear on the face of a certificate along with the word "cancelled" to evidence that the certificate no longer has any market value and that it no longer represents a claim against the issuer; (vii) in the case of redeemable securities of investment companies (e.g., securities issued by open-end management companies and other investment companies registered under Section 8 of the Investment Company Act), an appropriate description of each debit and credit (i.e., designation indicating purchase, redemption, or transfer); and (viii) "[a]ny other identifiable information about securities and securityholders" that the transfer agent reasonably deems essential to its recordkeeping system for the efficient and effective research of record differences.[231]

"Master securityholder file" is defined as the official list of individual securityholder accounts. With respect to uncertificated securities of investment companies registered under the Investment Company Act, the master securityholder file may consist of multiple, but linked, automated files.[232]

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231 Exchange Act Rule 17Ad-9(a), 17 CFR 240.17Ad-9(a).

232 Exchange Act Rule 17Ad-9(b), 17 CFR 240.17Ad-9(b). In other contexts, the master securityholder file may be referred to as a "stockholder register," "stockholder list," "shareholder ledger," or some other designation. As used throughout this release, we refer to it as the master securityholder file. See, e.g., Del. Code Ann. tit. 8 §220 (referring to a corporation's "stock ledger" as well as its "list of its stockholders").

A "subsidiary file" is any list of record of accounts, securityholders, or certificates that evidences debits or credits that have not been posted to the master securityholder file.[233]

A "control book" is the record or other document that shows the total number of shares (in the case of equity securities) or the principal dollar amount (in the case of debt securities) authorized and issued by the issuer.[234] The control book may be referred to in the industry as a registrar journal, and is one of the mechanisms transfer agents use to monitor against overissuance.[235]

A "credit" is an addition of appropriate certificate detail to the master securityholder file, and a "debit" is a cancellation of appropriate certificate detail to the master securityholder file.[236]

A "record difference" occurs when either: (i) the total number of shares or total principal dollar amount of securities in the master securityholder file does not equal the number of shares or principal dollar amount in the control book; or (ii) the security transferred or redeemed contains certificate detail different from the certificate detail currently on the master securityholder file, which difference cannot be immediately resolved.[237]

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233 Exchange Act Rule 17Ad-9(c), 17 CFR 240.17Ad-9(c).

234 Exchange Act Rule 17Ad-9(d), 17 CFR 240.17Ad-9(d).

235 The Commission's transfer agent rules do not provide a definition of "overissuance" or explicitly import a definition from other authorities that have defined this term. The UCC provides a definition of this term which has been amended over the years and currently provides: "In this section 'overissue' means the issue of securities in excess of the amount the issuer has corporate power to issue, but an overissue does not occur if appropriate action has cured the overissue." U.C.C. 8-210(a). One way in which an overissue can occur is when a corporation issues more shares than are authorized under its charter, such as its articles of incorporation. Under state law, shares over issued in such a manner may be deemed void. See, e.g., Del. Gen. Corp. L. §§ 161, 242(a)(3). For more information concerning the general concept of "overissuances" and types of transactions in which overissuances can occur, see Guttman, supra note 6, at § 11:7; Rhodes, supra note 18, at § 22:3.

236 Exchange Act Rule 17Ad-9(e), (f), 17 CFR 240.17Ad-9(e), (f).

237 Exchange Act Rule 17Ad-9(g), 17 CFR 240.17Ad-9(g).

A "recordkeeping transfer agent" is the registered transfer agent that maintains and updates a security's master securityholder file.[238] All other transfer agents associated with a given issue of securities are defined as "co-transfer agents," which are registered transfer agents that transfer securities but do not maintain and update the master securityholder file.[239] A co-transfer agent may include an outside registrar that keeps only the control book as defined in Rule 17Ad-1(b). A "named transfer agent" is the registered transfer agent that is engaged by an issuer to perform transfer agent functions for an issue of securities but has engaged a service company to perform some or all of those functions.[240] And a "service company" is the registered transfer agent engaged by a named transfer agent to perform transfer agent functions for that named transfer agent.[241]

Finally, Rule 17Ad-9(l) clarifies that the term "file" includes both automated and manual records.[242]

Rule 17Ad-10[243] requires each recordkeeping transfer agent to post promptly certificate detail to its master securityholder file after a security is transferred, purchased, or redeemed. The meaning of the term "promptly" varies with the relevant transaction but generally is five business days, although for exempt transfer agents under Rule 17Ad-4(b) promptly means 30 calendar days and for transfer agents functioning solely for their own or their affiliated companies'

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238 Exchange Act Rule 17Ad-9(h), 17 CFR 240.17Ad-9(h).

239 Exchange Act Rule 17Ad-9(i), 17 CFR 240.17Ad-9(i).

240 Exchange Act Rule 17Ad-9(j), 17 CFR 240.17Ad-9(j).

241 Exchange Act Rule 17Ad-9(k), 17 CFR 240.17Ad-9(k).

242 Exchange Act Rule 17Ad-9(l), 17 CFR 240.17Ad-9(l).

243 Exchange Act Rule 17Ad-10, 17 CFR 240.17Ad-10.

securities and using batch processing promptly means ten business days.[244] Timely updating of the master securityholder file is required because delayed posting or the failure to post would promote the proliferation of record inaccuracies that could impede the accurate payment of dividends and the processing of proxy solicitations.[245] Rule 17Ad-10(g) requires, with certain exceptions, that any transfer agent that erroneously issues securities that result in an overissuance[246] must "buy-in" (i.e., purchase securities in the open market) securities equal to the number of shares (in the case of equity securities) or principal dollar amount (in the case of debt securities) of the overissuance.[247] The buy-in requirement is designed to deter transfer agents from permitting record differences to accrue and encourages them to maintain complete and accurate records that assure that securityholders will receive all appropriate corporate distributions and communications.[248]

Rule 17Ad-11[249] requires that within ten business days following the end of each month, registered recordkeeping transfer agents report to issuers and the ARA certain information regarding aged record differences[250] when the dollar amount or the number of shares regarding

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244 See 17Ad-9 through 13 Proposing Release, supra note 2.

245 See infra Section V.B. for further discussion of proxy services.

246 See supra note 235.

247 Exchange Act Rule 17Ad-10(g)(1), 17 CFR 240.17Ad-10(g)(1).

248 See Maintenance of Accurate Securityholder Files and Safeguarding of Funds and Securities by Registered Transfer Agents, Exchange Act Release No. 19860 (June 10, 1983), 48 FR 28231 (June 21, 1983) ("Adopting Release for Rule 17Ad-10").

249 Exchange Act Rule 17Ad-11, 17 CFR 240.17Ad-11.

250 Exchange Act Rule 17Ad-11(a)(2), 17 CFR 240.17Ad-11(a)(2). A record difference becomes an aged record difference if it exists for "more than thirty calendar days."

those shares reach certain preset levels.[251] The reports required by 17Ad-11 must set forth the amount of aged record differences, the reasons for any difference, and the steps being taken to resolve any difference.

Rule 17Ad-12[252] requires registered transfer agents to safeguard funds and securities of which they have custody or possession in a manner reasonably free from theft, loss, destruction, or misuse, in light of all the facts and circumstances including the cost of particular safeguards and procedures that might be employed. A reasonable level of safeguarding is necessary due to various duties of transfer agents which may include, for example: (i) holding balance certificates as transfer agent custodians; (ii) administering DRIPs which involves the holding of funds and securities; (iii) making distributions, including of principal, interest and dividends, as paying agents of issuers;[253] and (iv) maintaining working inventories of unissued securities certificates.[254]

Rule 17Ad-13[255] requires registered transfer agents, with certain exceptions, to file annually with the Commission a report prepared by an independent accountant concerning the transfer agent's system of internal controls and related procedures for the transfer of record ownership and the safeguarding of related securities and funds based on an annual study and evaluation made in accordance with generally accepted auditing standards. The purpose of the

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251 Exchange Act Rule 17Ad-11(b)(1), 17 CFR 240.17Ad-11(b)(1). The dollar amounts and share thresholds reflected in the table set forth in Rule 17Ad-11(b)(1) have not been modified since Rule 17Ad-11 was first adopted in 1983.

252 Exchange Act Rule 17Ad-12, 17 CFR 240.17Ad-12.

253 See generally, Section VI.C for discussion of paying agent services.

254 Id.

255 Exchange Act Rule 17Ad-13, 17 CFR 240.17Ad-13.

rule is to ensure that transfer agents have a system of internal controls adequate to provide reasonable assurances that securities and funds held by transfer agents – for example, when a transfer agent facilitates a dividend or interest payment for an issuer – are safeguarded against loss from unauthorized use or disposition and that transfer agent activities are performed promptly and accurately. The rule requires that the independent accountant's report state whether the annual study and evaluation was made in accordance with generally accepted auditing standards using the criteria set forth in the rule and describe and comment upon any material inadequacies found to exist in the system of internal accounting control as of the date of the evaluation and any corrective action taken, or state that no material inadequacy exists.[256] An accountant preparing reports under this rule is expected to use the general standards established by the American Institute of Certified Public Accountants ("AICPA").[257]

### 4. *Issue-Specific Rules: Rules 17Ad-14 Through 17Ad-21T.*

After the adoption of Rules 17Ad-8 through 17Ad-13, between 1983 and 2013 the Commission continued to adopt new rules to address specific issues. Specifically, Rules 17Ad-14 through 17Ad-20, as well as 17Ad-21T, address issues such as tender agent services, signature guarantee programs, notifications when transfer agents begin or cease acting for specific issues, lost shareholder searches, processes for cancelling certificates, transfer of restricted securities, and anticipated risks associated with Year 2000 compliance.

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256 See Adopting Release for Rule 17Ad-10, supra note 248.

257 Id.

Rule 17Ad-14[258] requires a registered transfer agent that acts as a tender agent or a depositary for a party making a tender or exchange offer to establish and maintain special accounts with all qualified registered securities depositories that hold the subject company's securities, thereby enabling depository participants to move securities to and from the tender agent by book-entry.[259] Unless a bidder's depositary establishes an account with a securities depository, all the subject securities must be tendered in physical certificate form, rather than by book-entry, which causes inefficiencies and other problems for securityholders, broker-dealers, bidders, tender agents, and others.[260] The purpose of this rule is to reduce the processing costs and trading inefficiencies that occur when tender offers are processed in a physical certificate environment and to make the benefits of processing tender offers by book-entry available to the investing public and the securities industry.[261]

For example, securityholders sometimes have difficulty obtaining properly denominated physical certificates for tender to the bidder's depository prior to the offer's expiration date. Also, instances where there is unavailability of book-entry settlement have resulted in a substantially higher number of fails-to-deliver between broker-dealers. As a result, broker-dealers who are unable to satisfy tender obligations may have to buy securities in the cash market for same-day delivery (i.e., delivery on the day of the contract), which may create significant price disparities between the cash market and the regular-way market (i.e., delivery on the third

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258 Exchange Act Rule 17Ad-14, 17 CFR 240.17Ad-14.

259 See discussion infra at p. 104 for definition of "tender agent."

260 Processing of Tender Offers Within the National Clearance and Settlement System, Exchange Act Release No. 20581 (Jan. 19, 1984), 48 FR 17603 (Apr. 25, 1983).

261 Id.

business day following the day of the contract).[262] Prior to the adoption of Rule 17Ad-14, bidders could insist upon the tender of physical securities certificates outside of securities depositories (such as to the bidder's broker or local bank), even if the delivering entities were depository participants and even if the securities themselves were depository eligible. Doing so not only increased the number of fails, but increased brokerage firms' financing expenses and made it more difficult to settle transactions in a timely way.[263]

Rule 17Ad-15[264] prohibits inequitable treatment of eligible guarantor institutions (e.g., banks, brokers, and other financial institutions) that provide signature guarantee programs. The rule implements Section 17A(d)(5) of the Exchange Act which expressly bars transfer agents from exercising inequitable treatment of financial institutions with respect to security guarantees.[265] The signature guarantee program requires that a securities certificate bear a signature by a guarantor institution with a medallion stamp backed by a surety bond before the transfer agent will accept the certificate for transfer. The guarantee program allows the high-speed processing of a large volume of securities certificates that would be impossible if transfer agents had to examine the creditworthiness of the person behind each certificate being presented. Specifically, the program establishes requirements for its members with respect to guaranteeing and accepting securities certificates. The indorsing signature on a securities certificate is

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262 Regular way settlement generally refers to settlement that occurs on a T+3 basis as required pursuant to Exchange Act Rule 15c6-1. Exchange Act Rule 15c6-1, 17 CFR 240.15c6-1. For additional information on cash, regular way, and other delivery schedules, see NYSE Rule 64 (2009).

263 For a discussion of tender offers and trade processing problems that arise when depository book-entry services are not used during tender offers, see Rule 17Ad-14 Proposing Release, supra note 116.

264 Exchange Act Rule 17Ad-15, 17 CFR 240.17Ad-15.

265 Exchange Act Section 17A(d)(5), 15 U.S.C. 17q-1(d)(5).

guaranteed, typically by a financial institution, by the placement of a signature of the guarantor or its representative and a medallion stamp backed by a surety bond which, in effect, states that in event of mishap, the surety will pay for any damages incurred as a result of a forged signature if the guarantor does not pay.[266] With these assurances of financial safety, a transfer agent is able to accept a securities certificate without further examination or delay, as is required by the terms of the program.[267] Rule 17Ad-15 requires transfer agents to establish written standards for the acceptance of signature guarantees, and it authorizes signature guarantee programs. It also enables transfer agents to reject a request for transfer where a securities certificate is not guaranteed and bears no medallion stamp or where the guarantor is neither a member nor a participant in a signature guarantee program.[268]

Rule 17Ad-16 requires a registered transfer agent to provide written notice to an "appropriate qualified registered security depository" (i.e., DTC)[269] when terminating or

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266 The UCC provides: "A person who guarantees a signature of an indorser of a securities certificate warrants that at the time of signing: (1) the signature was genuine; (2) the signer was an appropriate person to indorse, or if the signature is by an agent, the agent had actual authority to act on behalf of the appropriate person; and (3) the signer had legal capacity to sign." U.C.C. 8-306.

267 There are currently three organizations that provide signature guarantee programs to their members: Securities Transfer Agent Medallion Program, Stock Exchange Medallion Program, and New York Stock Exchange Medallion Program. See, e.g., Signature Guarantees: Preventing the Unauthorized Transfer of Securities, SEC, http://www.sec.gov/answers/sigguar.htm.

268 See Acceptance of Signature Guarantees from Eligible Guarantor Institutions, Exchange Act Release No. 30146 (Jan. 6, 1992), 57 FR 1082 (Jan. 10, 1992) (adopting release for Rule 17Ad-15).

269 Rule 17Ad–16 defines an ''appropriate qualified registered securities depository'' as the "qualified registered securities depository" that the Commission so designates by order or, in the absence of such designation, the qualified registered securities depository that is the largest holder of record of all qualified registered securities depositories as of the most recent record date. In 1995, the Commission issued an order approving a DTC rule filing in which DTC was designated as the "appropriate qualified registered securities depository" to receive notices of transfer agent changes pursuant to Rule 17Ad-16 in order to eliminate uncertainty about where registered transfer agents should direct Rule 17Ad-16 notices, and to reduce unnecessary costs and administrative burdens for transfer agents and registered securities

assuming transfer agent services on behalf of an issuer or when changing its name or address.[270] The rule is intended to address the problem of unannounced transfer agent changes that adversely affect the prompt transfer of securities certificates by causing needless delays, costs, and risks.[271] Depositories and other entities in the marketplace must have the correct information in order to send transfer instructions to the appropriate transfer agent at the correct address. In addition to causing delay in execution of the instructions, certificates sent to the wrong address may result in a loss of certificates.

Rule 17Ad-17 is designed to ensure that the transfer agents, brokers, dealers, and other financial intermediaries make adequate efforts to find lost securityholders.[272] It was first adopted in 1997[273] and later amended at the beginning of 2013.[274] The rule defines "lost securityholder" as a securityholder for whom an item of correspondence sent to his or her last known address was "returned as undeliverable" and requires transfer agents, brokers, and dealers to conduct two database searches in their efforts to locate a lost securityholder. It defines "unresponsive payee" to mean a securityholder to whom a paying agent has sent a regularly scheduled check which was not cashed or otherwise negotiated before the earlier of either the paying agent's sending the next regularly scheduled check or of 6 months after the sending of the not yet negotiated

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depositories. See Securities Exchange Act Release No. 35378 (Feb. 15, 1995), 60 FR 9875 (Feb. 22, 1995) (File No. SR-DTC-95-02).

270 Exchange Act Rule 17Ad-16, 17 CFR 240.17Ad-16.

271 Adopting Release for Rule 17Ad-16, supra note 147.

272 Exchange Act Rule 17Ad-17, 17 CFR 204.17Ad-17.

273 Lost Securityholders, Exchange Act Release No. 39176 (Oct. 1, 1997), 62 FR 52229 (Oct. 7, 1997).

274 Lost Securityholders and Unresponsive Payees, Exchange Act Release No. 68668 (Jan. 16, 2013), 78 FR 4768 (Jan. 23, 2013) ("Adopting Release for 17Ad-17 Amendments").

check.[275] Any "paying agent," defined for purposes of Rule 17Ad-17 as "any broker, dealer, investment advisor, indenture trustee, custodian, or any other person that accepts payments from the issuer of a security and distributes the payments to the holders of the security," shall provide to each unresponsive payee not less than one written notice stating that such payee has been sent a check that has not yet been negotiated.

Rule 17Ad-19 was adopted in 2003 and requires every transfer agent to establish and implement written procedures for the cancellation, storage, transportation, destruction, or other disposition of securities certificates.[276] Specifically, it requires transfer agents to mark each cancelled securities certificate with the word "cancelled," to maintain a secure storage area for cancelled certificates, to maintain a retrievable data base for of all its cancelled, destroyed, or otherwise disposed of certificates, and to have specific procedures for the destruction of cancelled certificates. The rule was adopted in response to a series of major thefts of cancelled certificates from transfer agent facilities, after which the stolen certificates were recirculated into the marketplace on a massive scale and fraudulently sold or used as loan collateral.[277]

Rule 17Ad-20 prohibits registered transfer agents from effecting the transfer of any equity security registered pursuant to Section 12 or that subjects an issuer to reporting under Section 15(d) of the Exchange Act if such security is subject to any restriction or prohibition on

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275 Id.

276 Exchange Act Rule 17Ad-19, 17 CFR 240.17Ad-19.

277 See 17Ad-19 Adopting Release, supra note 2. We note that in more than a decade since the adoption of Rule 17Ad-19, we are not aware of any major thefts of cancelled securities certificates or their unlawful recirculation back into the marketplace.

transfer to or from a securities intermediary in its capacity as such.[278] In the 2004 adopting release for the rule, the Commission observed that issuers imposing such restrictions on transfer to intermediaries believe that "precluding ownership by certain securities intermediaries forces broker-dealers to deliver certificates on each transaction and eliminates the ability of naked short sellers to maintain a naked short sale position."[279] The Commission believed Rule 17Ad-20 was necessary to prevent transfer agent facilitation of the transfer of securities subject to such restrictions, because these types of restrictions disrupted prompt and efficient clearing and settlement in the U.S. securities markets.

Two rules relate to Year 2000 compliance. Rule 17Ad-18 (Year 2000 Reports to be Made by Certain Transfer Agents) was adopted by the Commission on July 13, 1998 and required non-bank transfer agents to, among other things, file a report attesting to the Y2K compliance of their mission critical computer systems by August 31, 1998.[280] The rule also required non-bank transfer agents to notify the SEC of any material Y2K problems that would affect the millennium transition. Similarly, Rule 17Ad-21T required non-bank transfer agents to ensure that their mission critical computer systems were Year 2000 compliant by August 31, 1999 or to fix any non-compliant systems by November 5, 1999.[281] The purpose was to reduce risk to investors and the securities markets that were posed by non-bank transfer agents that had not adequately prepared their computer systems for millennium transition.

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278 Exchange Act Rule 17Ad-20, 17 CFR 240.17Ad-20.

279 See Issuer Restrictions or Prohibitions on Ownership by Securities Intermediaries, Exchange Act Release No. 50758, text following n.41 (Nov. 30, 2004), 70 FR 70852 (Dec. 9, 2004) (adopting release for Rule 17Ad-20). See also U.C.C. 8-501 et seq.

280 Exchange Act Rule 17Ad-18, 17 CFR 240.17Ad-18.

281 Exchange Act Rule 17Ad-21T, 17 CFR 240.17Ad-21T.

## B. Bank and Internal Revenue Service Regulations

There are approximately 95 registered transfer agents that are banks or subsidiaries of banks. For national banks and banks operating under the Code of Law for the District of Columbia, the ARA is the Office of the Comptroller of the Currency ("OCC"); for State member banks, subsidiaries thereof, bank holding companies, and bank subsidiaries thereof the ARA is the Federal Reserve Board; and for banks insured by the FDIC (non-members of the Federal Reserve), the ARA is the FDIC. Collectively, we refer to transfer agents registered with the OCC, FDIC, or Federal Reserve Board as "bank transfer agents." For non-bank transfer agents (i.e., all other transfer agents), the ARA is the Commission.[282]

Prior to the 1975 Amendments and the adoption of the Commission's transfer agent rules discussed in Section IV.A above, many of the organizations performing transfer agent services were banks or trust companies regulated by bank regulators. As noted in the Unsafe Practices Study, at that time, "[t]he power of the bank regulatory officials over the transfer function [was] not specific. Rather their concern [was] whether the performance of the transfer function may endanger the financial stability of the bank."[283] Today, pursuant to the 1975 Amendments and the Commission's transfer agent rules enacted thereunder, bank transfer agents must comply with both the Commission's transfer agent rules and any applicable rules promulgated by their ARA. Accordingly, bank transfer agents who are required to register as a transfer agent under

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282 Exchange Act Section 3(a)(34), 15 U.S.C. 78c(a)(34).

283 See Unsafe Practices Study, supra note 17, at 38. In contrast, the Exchange Act and the rules and regulations promulgated thereunder, including the Commission's transfer agent rules, are focused on protecting investors and the securities markets. See Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145 (noting the importance of avoiding impediments to "the Commission's efforts to provide necessary or appropriate regulations for transfer agents in the broader context of the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions.").

the Exchange Act initially register with their appropriate ARA, but must file an annual Form TA-2 with the Commission.[284] The bank ARAs have not promulgated separate rules designed to address specifically the transfer functions of bank transfer agents, but instead generally require bank transfer agents to comply with the Commission's transfer agent rules. OCC, for example, explicitly applies the Commission's transfer agent rules to the "domestic activities of registered national bank transfer agents."[285] Similarly, the Federal Reserve Board's rules provide that the Commission's transfer agent rules "apply to member bank transfer agents."[286] The FDIC has stand-alone registration requirements for transfer agents and may examine transfer agents for both safety and soundness considerations under applicable banking regulations and for compliance with the Commission's transfer agent rules.[287]

With respect to examination and enforcement, both the ARA and the Commission have examinations powers over bank transfer agents, however, the Commission must provide notice to the appropriate ARA prior to conducting an examination and to arrange for a joint examination where desired.[288] In addition, both the Commission and the ARA have enforcement authority over bank transfer agents.[289]

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284 See supra Section IV.A.1.

285 12 CFR 9.20.

286 12 CFR 208.31.

287 See FDIC Trust Examination Manual, sec. 11.B.1.b (Statutory Framework), available at https://www.fdic.gov/regulations/examinations/trustmanual/section_11/section11toc.html ("Registered Transfer Agent Examination Manual").

288 See Exchange Act Section 17(b), 15 U.S.C. 78q(b).

289 See generally, Exchange Act Section 17A(d), 15 U.S.C. 78q-1(d).

In addition to complying with the Commission's transfer agent rules, bank transfer agents must also comply with their ARA's rules and standards. Those may supplement or exceed the Commission's rules. In part, this may be due to the fact that a bank transfer agent's activities could impact the proper functioning of the bank itself. As the FDIC explains in Section 11 of its Trust Examination Manual, one rationale for its transfer agent examination program is to "to detect and prevent situations which might threaten the viability of banks through diminution of their capital accounts."[290] It further notes that "to the extent that a registered transfer agent fails to conduct transfer agent operations in a safe and efficient manner . . . the transfer agent function could incur contingent liabilities or estimated losses which could adversely impact the bank's capital accounts."[291]

As a result, for example, the FDIC examines its transfer agents for internal control and risk management policies and procedures that are similar to what is required for banks.[292] With respect to internal controls, the FDIC specifies not only what it expects from the agent in order to demonstrate compliance with the Commission's rules, but additional standards as well. These standards apply whether the transfer agent is housed within the bank's trust department, is its own operating unit, or if the transfer agent activities are outsourced. The FDIC specifies suggested means for ensuring control over physical security, such as controlled access, secure safes and cabinets, and maintenance of access logs, and generally expects to see management oversight of operations consistent with bank management oversight. Supervision of the transfer

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290 See Registered Transfer Agent Examination Manual, supra note 287, at sec. 11.B (Introduction discussing the rationale for transfer agent examinations).

291 Id. at sec. 11.B.1.b (The Statutory Framework).

292 Id. at sec. 11.G (Management), sec. 11.H (Internal Controls).

agent operations may be delegated, but ultimately rests with the bank's Board and senior management.[293]

Separately, depending on its duties, an OCC-registered transfer agent also may have to comply with statutory requirements for the treatment of "assets held in any fiduciary capacity."[294] For example, entities servicing in a fiduciary capacity may be required to segregate the fiduciary funds from the "general assets" of the bank and have a separate accounting for transactions involving the segregated funds.[295]

In addition, depending on the nature and scope of the services that transfer agents provide, they must comply with certain regulations and other guidance issued by the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service. For example, transfer agents track and report to the Internal Revenue Service the dividend income and share sale activity they facilitate on behalf of issuers via Form 1099 reporting,[296] and follow federal law requirements concerning tax withholding, where appropriate.[297]

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293 Id.

294 12 U.S.C. 92a(c). See also 12 CFR 9.2 ("Fiduciary capacity" includes transfer agents and registrars of stocks and bonds).

295 12 U.S.C. 92a(c).

296 See 2016 Instructions for Form 1099-DIV, available at http://www.irs.gov/pub/irs-pdf/i1099div.pdf (last visited November 20, 2015) (generally for information regarding disclosure of dividend payments).

297 For example, the Foreign Account Tax Compliance Act ("FATCA"), enacted in 2010, is intended to reduce tax evasion by U.S. individuals with respect to income from financial assets held outside the United States by requiring foreign financial institutions to, among other things, report directly to the Internal Revenue Service certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. See Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, §§501-541 (1986). Under FATCA, foreign financial institutions such as investment funds domiciled outside the United States are permitted to contract with their transfer agents or other agents to perform certain due diligence and other FATCA obligations on their behalf. A transfer agent's service agreement may take into account these new responsibilities, under which the transfer agent may be required to perform due diligence on all investors listed in the investor record, report on U.S. individuals and

C. SRO Rules and Requirements Applicable to Transfer Agents

This section discusses some of the SRO rules and requirements applicable to transfer agents. While we focus here on NYSE and DTC requirements, we do so by way of example only. Other SROs may have additional rules which could apply to transfer agents in different contexts.

*1. NYSE Requirements*

Transfer agents for NYSE listed securities are also subject to NYSE requirements. The requirements focus on (i) dual registrars and transfer agents; (ii) turnaround times; (iii) capitalization; and (iv) insurance coverage. The requirements also address transfer agent personnel, safeguarding, and co-transfer agents.

First, the NYSE Listed Company Manual ("NYSE LCM"), Section 601.01(B), provides that one person may serve as both registrar and transfer agent subject to compliance with the following conditions: (i) meeting insurance and net capital requirements (discussed in more detail below); (ii) maintaining the functions separately and distinctly with appropriate internal controls; (iii) annual review of such internal controls by the transfer agent's independent auditors; (iv) submitting financial statements to the exchange; and (v) obtaining a certification from the transfer agent's insurer that NSYE insurance requirements have been met. This provision is less restrictive than stock exchange prohibitions on serving as a dual registrar and transfer agent that

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institutions investing in the fund, and apply FATCA withholding to certain payments. For more information on regulations, rulings, notices, announcements, and other FATCA-related guidance or requirements for financial institutions, see, e.g., FATCA- Regulations and Other Guidance, IRS, http://www.irs.gov/Businesses/Corporations/FATCA-Regulations-and-Other-Guidance.

existed in earlier eras.[298] It is the understanding of the Commission staff that outside or independent registrars are rarely used today.[299]

Second, as noted above, NYSE also imposes turnaround time requirements. NYSE LCM Section 601.01(A)(2) requires that routine transfers (as defined in Exchange Act Rule 17Ad-1) "must be processed under normal conditions within 48 hours of receipt of the securities by the transfer agent at its address designated for registration of transfers." The 48 hour turnaround requirement was adopted by the NYSE in 1971 (originally as Rule 496) in the immediate wake of the transfer agent problems during the Paperwork Crisis.[300] The Commission adopted its Rule 17Ad-2 turnaround requirement (providing for three day turnaround) approximately six years later in 1977. In the adopting release for Rule 17Ad-2, the Commission stated "The adopted rules are not intended to and do not supersede any rules of self-regulatory organizations which impose more stringent performance standards."[301]

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298 See Rockwell Study, supra note 19, at 101 (1969 study discussing NYSE prohibition on serving as dual registrar and transfer agent); Securities Exchange Act Release No. 21499, File No. SR-NYSE-84-33 (Nov. 19, 1984) (discussing prior 1971 NYSE rule change permitting banks and trusts to serve as dual registrar and transfer agent and approving NYSE rule change to eliminate prohibition on acting as dual transfer agent and registrar that had applied to transfer agents other than banks and trusts, subject to certain conditions).

299 Separate registrars and transfer agents still were common between 1977 and 1983, when the Commission adopted the majority of its transfer agent rules. Although even by that point, stock exchanges had relaxed certain prohibitions on serving as dual transfer agent and registrar, the practice often was followed because many securities industry participants believed that the independent registrar served an audit function that protected investors. See Study of the Securities Industry: Hearings Before the Subcomm. on Commerce and Fin. of the H. Comm. on Interstate and Foreign Commerce, 92nd Cong. app. DD 2391 (1971) ("1971 Study of the Securities Industry Hearings") (Statement of Herman W. Bevis, Executive Director of BASIC).

300 See Securities Exchange Act Release No. 21499, File No. SR-NYSE-84-33 n.16 (Nov. 19, 1984) (noting the NYSE adopted the 48 hour turnaround policy in 1971); 2011 NYSE Rule Archives, Rule 496.

301 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at 32404 n.4.

Third, NYSE LCM Section 601.01(A)(1)(i) requires that a transfer agent must have at least $10 million in "capital, surplus (both capital and earned), undivided profits, and capital reserves." Where a transfer agent is unable to meet this capital requirement, NYSE LCM Section 601.01(A)(12) provides for a lower alternative capital standard of $2 million that the transfer agent may meet if it maintains certain additional insurance coverage.[302] The requirements may also be satisfied by a parent company.[303] Fourth, NYSE LCM Section 601.01(A)(1)(ii) requires that a transfer agent maintain insurance coverage of at least $25 million "to protect securities while in process."[304]

The NYSE also requires transfer agents to be staffed with "experienced personnel qualified to handle so-called 'legal terms' and to advise on and handle other transfer problems."[305] A transfer agent is also required to assume responsibility and liability for securities in its possession and must "provide adequate facilities for the safekeeping of securities in its possession or under its control."[306] Additional provisions address other items specific to the NYSE, co-transfer agents, and independent registrars.[307]

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302 See NYSE Listed Co. Manual §601.01(A)(12) (2013) (making the lower capital standard conditional on the maintenance by the transfer agent of "errors and omissions insurance coverage in an amount which, taken together with its capital, surplus (both capital and earned), undivided profits, and capital reserves, equals at least $10,000,000 and, provided further, that such transfer agent maintains the insurance required by Para.601.01(A)(1)(ii).")

303 NYSE Listed Co. Manual §601.01(A)(10) (2013).

304 NYSE Listed Co. Manual §601.01(A)(1) (2013).

305 NYSE Listed Co. Manual §601.01(A)(6) (2013).

306 NYSE Listed Co. Manual §601.01(A)(4),(7) (2013).

307 See generally, NYSE Listed Co. Manual §601.01(A)-(D) (2013).

### 2. *DTC Requirements*

Transfer agents who participate in DRS must comply with DTC rules and regulations. Many transfer agents participate in DRS, especially because national U.S. securities exchanges, including NYSE and NASDAQ, require newly listed securities to be DRS eligible.[308]

DTC requires transfer agents to satisfy four primary requirements before being eligible to process DRS transactions, including the following:

- Because DRS is integrated for communication purposes into DTC's Profile system, transfer agents must become "Limited Participants" in DTC by submitting an application to the DRS Program Administration for DTC approval.[309]
- Participate in DTC's FAST program by becoming a FAST agent and agreeing to DTC's Operational Criteria for FAST Transfer Agent Processing ("FAST criteria"). The FAST criteria outline rules for securities transfers through FAST, DTC's Operational Arrangements, and DTC's Balance Certificate Agreement. The Operational Arrangements include, among other things, DTC's requirements for issues to be DTC-eligible, additional transfer requirements for FAST agents, record date requirements, and dividend and income notification procedures. By signing the Balance Certificate Agreement with DTC, transfer agents agree to maintain DTC-eligible inventory in the form of jumbo certificates registered in

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308 See NYSE Listed Co. Manual §501.00 (2013) (requiring "all securities listed on the Exchange [to] be eligible for a direct registration system operated by a securities depository"); NASDAQ Rule 5210(c) (requiring "all securities initially listing on Nasdaq, except securities which are book-entry only, [to] be eligible for a Direct Registration Program operated by a clearing agency registered under Section 17A of the [Exchange] Act.").

309 Profile was implemented by DTC in 2000 to "electronically convey an investor's request to move from one form of securities ownership to another. Profile takes the place of the paper transaction advice for electronic movement of securities positions between street-name positions and direct registration book-entry positions. Profile includes all the data fields listed on the paper transaction advice, including the investor's broker-dealer account number, investor's DRS account number, Tax I.D./Social Security number, full registration, and CUSIP." DTC, An Overview, available at http://www.dtc.org/dtcpublic/html/lob2/prod6/drsdetail.htm. In addition, since 2001, the Profile Surety Program has provided for a surety bond to help mitigate the risks for parties using DRS and Profile, similar to a medallion stamp on a certificated security.

the name of DTC's nominee, Cede & Co., and that they will electronically reconcile DTC participants' daily deposit and withdrawal activities.

- Establish and maintain electronic communication links with DTC through Profile so that DTC participants (e.g., broker-dealers) and limited participants (e.g., transfer agents) can communicate investors' instructions electronically. DTC requires transfer agents to complete DRS and Profile training before using Profile. Profile includes data fields that would be included in a traditional paper transaction, including the investor's broker-dealer account number, investor's DRS account number, Tax I.D./Social Security number, and CUSIP numbers of the securities. Once those instructions are transmitted, the actual movement of securities ownership takes place in DRS.

- Participate in DTC's Profile Surety Program, which functions similarly to the medallion guarantee programs for paper based transactions by providing for a surety bond to back the representations made by the transacting parties.[310]

Additionally, DTC criteria that must be met by a securities issuer to ensure its securities are eligible for DRS and Profile may indirectly apply to transfer agents acting on behalf of the issuer. For example, DTC requires issuers to mail DRS book-entry statements to registered owners evidencing their holdings at least once a year.[311] Transfer agents acting on behalf of issuers wishing to participate in DRS may therefore be asked by their issuer clients to handle this statement mailing function.

D. Regulation of Transfer Agents Under State Law

Transfer agents are subject indirectly to state corporation law when acting as agents of corporate issuers, and they are directly subject to state commercial law, principal-agent law, and other laws, many of which are focused on corporate governance and the rights and obligations of

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310 See Securities Exchange Act Release No. 41862 (Sept. 10, 1999), 64 FR 51162, 51163 (Sept. 21, 1999) (File No. SR-DTC-99-16). See also supra note 86 (regarding FAST requirements).

311 DTC requirements for DRS and Profile eligible transfer agents and issuers are discussed in greater detail at Direct Registration System, DTCC, http://www.dtc.org/dtcpublic/html/lob2/prod6/drsdetail.htm (last visited November 20, 2015).

issuers and securityholders.[312] While a full discussion of all state laws applicable to transfer agents is beyond the scope of this release, the transfer of investment securities is primarily governed by UCC Article 8, which has been adopted by the legislatures of all 50 states,[313] the District of Columbia, Puerto Rico, and the Virgin Islands. Article 8 was most recently revised in 1994 to introduce the concept of a securities entitlement as a way to simplify and clarify the rules for the modern street name system.[314] Although UCC Article 8 is intended to provide a uniform and practical definition of the responsibilities of issuers and their agents in issuing and transferring securities, it does not encompass or preempt the complete body of state laws that may relate to transfer agent activity.[315] Transfer agents may also be subject to the laws of the states of incorporation for both issuers and their securityholders that apply to specific services provided by the transfer agent, such as data privacy.[316]

## V. EVOLUTION OF RECORDKEEPING, TRANSFER, AND RELATED TRANSFER AGENT ACTIVITIES

This section discusses some of the core recordkeeping, transfer, and other activities that transfer agents engage in, the manner in which the current transfer agent rules apply to those

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312 See, e.g., Del. Code Ann. tit. 8 (Delaware General Corporation Law), Del. Code Ann. tit. 6, art. 8 (Investment Securities), Restatement (Third) of Agency (2006).

313 Louisiana has enacted the provisions of Article 8 into the body of its law, among others, but has not adopted the UCC as a whole.

314 U.C.C. 8-501 et seq. (1994).

315 For example, in addition to UCC Article 8, various state laws relating to contracts, principal agent relationships, estoppel, fraud, bankruptcy, escheatment (or abandoned property) and other areas may apply to a specific transaction or situation.

316 For example, California's privacy statute which became effective in 2003, was the first significant effort by a state to assert substantive regulation of privacy of customer data. See Cal. Civ. Code §§ 1798.80–1798.84. While state regulations vary across jurisdictions, other states have followed suit with similar regulatory initiatives. See, e.g., Minn. Stat. § 325E.61, Neb. Rev. Stat. §§ 87-801–807.

activities, and how those activities have evolved over time. The world looks very different today than it did in 1977, when the first transfer agent rules were adopted. Since then, the increased use and decreased cost of technology, the expansion of corporate actions to bring securities into the public market, the continued dematerialization of securities, and other changes have resulted in significant evolution and changes to the types of services transfer agents provide and the manner in which they provide them. At the same time, with limited exceptions, the Commission's transfer agent rules have not been updated. As a result, there may be divergence between modern transfer agents' activities and the activities that the Commission's rules are designed to regulate.

A. Recordkeeping, Transfer, Issuance, and Corporate Actions

All transfer agents perform a number of core recordkeeping, transfer, and other services related to their primary function of facilitating the transfer of securities. This section discusses some of the activities transfer agents engage in with respect to these services and the relevant transfer agent rules applicable to them.

*1. Recordkeeping: Rules 17Ad-9, 10, and 11*

Transfer agents have direct responsibility for maintaining on behalf of the issuer the currency and integrity of the official list of the registered owners of an issuer's stocks and bonds, how those stocks and bonds are held, and how many shares or bonds each investor owns. This list is defined by Rule 17Ad-9(b) as the master securityholder file.[317] Without the master securityholder file, registered owners of an issuer's securities cannot be assured that they are

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[317] See Exchange Act Rule 17Ad-9(b), 17 CFR 240.17Ad-9(b).

recognized as such by the issuer and that they will receive corporate distributions, communications, and the other rights of security ownership to which they are entitled.[318]

Transfer agents also maintain and keep current the control book which is defined by Rule 17Ad-9(d) as the record of the total number of shares of equity securities or the principal dollar amount of debt securities authorized and issued by the issuer for each issue the transfer agent services.[319] As discussed above in Section IV.A.3, one of the main purposes of the control book is to allow the transfer agent to monitor the number of securities outstanding to prevent overissuance because the total number of shares reflected in the aggregate on the master securityholder file should match the number of shares authorized in the control book.[320]

Finally, pursuant to Rule 17Ad-6, transfer agents maintain the transfer journal.[321] The transfer journal can be a useful tool for transfer agents and issuers. For example, when reviewed in conjunction with the master securityholder file, the transfer journal may provide historical information regarding the issuance and transfer of a specific security or the holdings of a specific securityholder. The transfer agent rules do not define transfer journal nor codify requirements with respect to the transfer journal.

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318 See generally, e.g., Del. Code Ann. tit. 8 §§ 170, 173 (authorizing a corporation to pay cash and stock dividends under certain circumstances); Exchange Act Rule 14c-3, 17 CFR 240.14c-3 (requirement to furnish an annual report to securityholders); Del. Code Ann. tit. 8 §212 (providing for voting rights of stockholders and permitting them to vote by proxy); Del. Code Ann. tit. 8 §222 (requirement to send stockholder notice in advance of stockholder meeting).

319 Exchange Act Rule 17Ad-9(d), 17 CFR 240.17Ad-9(d).

320 When acting in this capacity, a transfer agent may be referred to as a "registrar." See Exchange Act Section 3(a)(25), 15 U.S.C. 78c(a)(25).

321 Exchange Act Rule 17Ad-6, 17 CFR 240.17Ad-6.

The primary recordkeeping rules that apply to the core records discussed above include Rules 17Ad-9, 17Ad-10, and 17Ad-11. These recordkeeping requirements are supplemented and reinforced by the recordkeeping and record retention and preservation requirements found in Rules 17Ad-6 and 17Ad-7. Rules 17Ad-9 and 17Ad-10 define the term master securityholder file, provide the specific information regarding a securityholder that must be maintained on the master securityholder file, defined in the rules as certificate detail,[322] and set specific timing deadlines for recording this information.[323] In addition, Rule 17Ad-10 imposes obligations on transfer agents to carry over any existing certificate detail where they succeed to the maintenance of a master securityholder file that was maintained in an earlier format or by a predecessor transfer agent.[324]

The Commission's transfer agent rules seek to promote accurate recordkeeping by transfer agents by establishing specific requirements when a transfer agent identifies a specific type of discrepancy in its records referred to in Rule 17Ad-9(g) as a record difference.[325] Rule 17Ad-10(b) requires transfer agents to "exercise diligent and continuous attention to resolve all

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322 See supra Section IV.A.3. We note that the "certificate detail" requirements in Rule 17Ad-9 apply to both certificated securities and book-entry positions. Further, while we focus here on Rule 17Ad-9's certificate detail requirements, Rule 17Ad-9(a)(4) is relevant to other rules that depend on obtaining securityholders' address information such as Rules 17Ad-12 and 17Ad-17. We also note that Rule 17Ad-9(b) permits registered investment companies to maintain multiple, but linked, automated files with respect to book-entry securities.

323 With certain exceptions, certificate details must be posted within five business days, unless a transfer agent is an "exempt transfer agent" under Rule 17Ad-4(b) or an issuer acting as its own transfer agent for its own securities. Exchange Act Rule 17Ad-10(a)(2)(i)-(ii), 17 CFR 240.17Ad-10(a)(2)(i)-(ii).

324 See Exchange Act Rule 17Ad-10(h), 17 CFR 240.17Ad-10(h). As discussed below in Section VI.B, the rule does not require predecessor transfer agents to turn over such information to the issuer or to a successor transfer agent.

325 Exchange Act Rule 17Ad-9(g), 17 CFR 240.17Ad-9(g). For additional discussion of the goals and objectives of the Commission's transfer agent rules, see supra Section IV.

record differences." Further, Rule 17Ad-10(b) requires that every recordkeeping transfer agent maintain and keep current an accurate master securityholder file and subsidiary files, and if a record difference is identified, then both the master securityholder file and subsidiary files must accurately represent all relevant debits and credits until the record difference is resolved.[326]

As discussed above, if a record difference exists for "more than thirty calendar days," it becomes an aged record difference under Rule 17Ad-11(a)(2).[327] Depending upon the aggregate market value of the aged record differences for a particular issuer and the capitalization of the issuer, Rule 17Ad-11(b) may require the transfer agent to send a monthly report to the affected issuer.[328] Depending on the total number of issuers serviced and the aggregate market value of all record differences across all issuers serviced, the transfer agent may also need to make reports to its ARA pursuant to Rule 17Ad-11(c).[329]

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326 Exchange Act Rule 17Ad-10(b), 17 CFR 240.17Ad-10(b). We also note that, as part of a transfer agent's obligation to monitor against overissuances, Rule 17Ad-10(g) imposes buy-in obligations when an actual physical overissuance has occurred that was caused by the transfer agent. Exchange Act Rule 17Ad-10(g), 17 CFR 240.17Ad-10(g). There are limited exceptions to this requirement. See Exchange Act Rules 17Ad-10(g)(2)-(3), 17 CFR 240.17Ad-10(g)(2)-(3).

327 Exchange Act Rule 17Ad-11(a)(2), 17 CFR 240.17Ad-11(a)(2).

328 Exchange Act Rule 17Ad-11(b), 17 CFR 240.17Ad-11(b). Rule 17Ad-11(b) also requires, without imposing any minimum threshold as with the amount of aged record differences, that the transfer agent report to issuers concerning any securities bought-in pursuant to Rule 17Ad-10(g) or reported as bought-in pursuant to Rule17Ad-10(c) during the preceding month.

329 Exchange Act Rule 17Ad-11(c), 17 CFR 240.17Ad-11(c). The report to the ARA must also include information concerning buy-ins required by Rule 17Ad-10 (g) when the aggregate market value of all buy-ins during a calendar quarter exceeds $100,000. Id.

### 2. *Securities Transfers, Exchanges, and Conversions: Rules 17Ad-9, 10, 12, and 19*

Transfer agents are integrally involved in effecting transfers of ownership of securities, as well as exchanging and converting securities.[330] For example, an equity sale would usually involve a transfer. In contrast, a stock-for-stock merger, where the equity security of Company A is exchanged for an equity security of Company B (and Company B is the disappearing company) would involve an exchange. Finally, a securityholder's election to convert a convertible debt security into an equity security would usually involve a conversion. While these transfer agent services vary in terms of definition, the transfer agent rules apply to all of them in substantially similar ways. Therefore, for the purposes of describing all of these services in the discussion that follows, we will focus on the activities and rules applicable to transfers.

In connection with transfers of certificated securities, the first steps in the transfer process are to match the certificate detail with the master securityholder file, verify the signature guarantee, and then cancel the negotiable certificate that has been presented for transfer. With respect to verifying the signature, presentation by the transferor typically involves providing the transfer agent an indorsed security certificate bearing a medallion stamp. In some cases, the indorsement and assignment may be made not on the certificate itself but by an executed power of attorney authorizing the transfer of ownership on the books of the issuer.[331]

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330 The terms "exchange" and "conversion" are used in Exchange Act Section 3(a)(25) and in the Commission's transfer agent rules but are not defined in the Commission's transfer agent rules. The term "exchange" is commonly used to refer to the trading of specific securities for another asset, usually without an accompanying change in ownership. The term "conversion" is commonly used to refer to the changing into or substitution of one security for another security or asset under specific conditions, also without an accompanying change in ownership.

331 See supra note 18 (regarding powers of attorney).

Rule 17Ad-19 governs certificate cancellation and requires that "every transfer agent involved in the handling, processing, or storage of securities certificates shall establish and implement written procedures for the cancellation, storage, transportation, destruction, or other disposition of securities certificates."[332] The rule grants transfer agents flexibility to develop their own procedures, but depending on which procedures they adopt (i.e., cancellation, destruction, or other disposition), they must comply with minimum requirements regarding three general areas: (i) the manner of cancellation and destruction of certificates; (ii) the storage and transport of cancelled certificates; and (iii) recordkeeping with respect to cancelled certificates.[333]

Rule 17Ad-12 governs the safeguarding of cancelled certificates. First, certificates that are cancelled generally must be stamped or perforated with the word "CANCELLED" and, for any cancelled certificate that is subsequently destroyed, the destruction of certificates must be witnessed by authorized personnel of the transfer agent or its designee.[334] Second, transfer agents must control access to the location where cancelled certificates are kept and transport of cancelled certificates must be made in a "secure manner."[335] If cancelled certificates are not

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332 Exchange Act Rule 17Ad-19(b), 17 CFR 240.17Ad-19(b).

333 Id.

334 Exchange Act Rules 17Ad-19(c)(2), (6), 17 CFR 17.24017Ad-19(c)(2), (6). The requirement to stamp or perforate the certificate as cancelled does not apply where "the transfer agent has procedures adopted pursuant to this rule for the destruction of cancelled certificates within three business days of their cancellation." In addition, a certificate may be marked "cancelled" and stored for a period of time before being destroyed.

335 Exchange Act Rules 17Ad-19(c)(1), (5), 17 CFR 240.17Ad-19(c)(1), (5).

destroyed, they must be retained for six years pursuant to Rule 17Ad-7(d).[336] Furthermore, Rule 17Ad-12 requires that cancelled certificates be "held in safekeeping and…handled, in light of all facts and circumstances, in a manner reasonably free from risk of theft, loss or destruction (other than by a transfer agent's certificate destruction procedures pursuant to § 240.17Ad-19)." Third, transfer agents must keep a record regarding each cancelled certificate that is in transit and records for each cancelled certificate and destroyed certificate that in both cases are "indexed and retrievable by CUSIP and certificate number."[337] These records must be kept for three years.

Once the old certificate has been cancelled, the next step in the transfer of a certificated security will generally involve recording the change of record ownership of the relevant securities on the master securityholder file. In the context of certificated securities, this is done by debiting the securities account of the transferor. Rule 17Ad-9(f) defines the term "debit" as "a cancellation of appropriate certificate detail from the master securityholder file." Because the cancellation date is one of the defined elements of certificate detail under Rule 17Ad-9, together

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336 We note that when the Commission adopted Rule 17Ad-19 in 2003 addressing among other things the destruction of certificates, it did not amend Rule 17Ad-7(d) to delete the requirement to retain cancelled security certificates for six years. But concurrently in 2003, the Commission amended Rule 17Ad-7(f) such that "the records required to be maintained pursuant to § 240.17Ad-6 may be retained using electronic or micrographic media…." See Exchange Act Rule 17Ad-7(f), 17 CFR 240.17Ad-7(f); Recordkeeping Requirements for Transfer Agents, supra note 215. We understand that many transfer agents today follow a practice of destroying certificates after a period of time in accordance with their individual policies and in compliance with Rule 17Ad-19 but keep electronic copies of the cancelled certificate by imaging it to comply with Rule 17Ad-7 as well as keeping the records required by Rule 17Ad-19(c)(4) for destroyed certificates.

337 Exchange Act Rule 17Ad-9(c)(5), 17 CFR 240.17Ad-9(c)(5). The record regarding cancelled certificates in transit must show the certificate numbers and CUSIP numbers. The records regarding both cancelled certificates and destroyed certificates must include "the CUSIP number, certificate number with any prefix or suffix, denomination, registration, issue date, and cancellation date." Exchange Act Rules 17Ad-9(c)(3)-(4), 17 CFR 240.17Ad-9(c)(3)-(4).

Rules 17Ad-9(a)(6) and 17Ad-10 have the effect of requiring that the cancellation date be posted to the master securityholder file, generally within five business days.[338]

The final step in the process of completing a transfer for a certificated security is for the transfer agent to issue (on behalf of the issuer) a new security to the transferee. The transfer agent's role in connection with the issuance stage of transfer is discussed in more detail in the next section below.

For uncertificated securities, transfer agents do not issue or cancel physical securities certificates when transferring securities. Instead, they effect book-entry transfers by registering the change in ownership on the master securityholder file, which does not involve the physical issuance and cancelling of securities certificates. The term "registering" means an official form of recording by a person charged with that function, which is accomplished under Exchange Act Rules 17Ad-9(h) and 17Ad-10(e) by updating the master securityholder file, as discussed above. Book-entry transfer may be accomplished through DTC's DRS using DTC's Profile system.[339] Once the transfer has been effected, the investor would receive from the transfer agent a statement of ownership that acknowledges his or her new DRS position.

### 3. *Securities Issuance: Rules 17Ad-1 and 2*

Transfer agents are also involved in the issuance of securities, which may be one of the final stages before completing a transfer, as discussed above, or could involve a primary offering

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338 Exchange Act Rules 17Ad-9-10, 17 CFR 240.17Ad-9-10. Moreover, Congress in the Dodd-Frank Act has taken another step to tighten recordkeeping of cancelled securities by adding "cancelled" securities as a category of securities that must be reported to the Commission or its designee. See Exchange Act Section 17(f)(1), 78 U.S.C. 187(f)(1).

339 See supra note 93.

of securities such as an initial public offering. Generally, from the perspective of the transfer agent facilitating a transfer, issuance will involve a credit to the transferee's securities account, as compared to the cancellation and transfer processes discussed above, which involve debiting the securities account of the transferor.

The clock for turnaround under Rules 17Ad-1 and 17Ad-2 begins when a transfer agent receives an item and ends when a transfer agent issues the new security. Thus, from the transfer agent's perspective, issuance is what stops the clock. Rule 17Ad-2(a) generally has the effect of imposing a three day deadline on turnaround of transfer of a routine item.[340] Rule 17Ad-1 provides in general terms that turnaround is achieved "when transfer is accomplished."[341] In turn, "transfer is accomplished" when "all acts necessary to cancel the certificate or certificates presented for transfer and to issue a new certificate or certificates...are completed and the item is made available to the presentor by the transfer agent..."[342] Thus, with certain exceptions, the "made available" standard [343] functions similar to a "mailbox" rule because the item is considered to have been made available when the transfer agent mails the new certificate to the transferee (or otherwise makes it available).

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340 If a transfer agent fails to turnaround 90% of routine items received during a month within three business days of receipt, certain sanctions apply. See discussion supra Section IV.B for additional details on the turnaround requirements and requirements in the event of failure to meet the turnaround requirements.

341 Rule 17Ad-1(c)(2) applies a different measurement of when turnaround is achieved when an outside registrar is involved: instead of the clock stopping when the new certificate is presented to the transferee, it stops when the item is "made available" to the outside registrar. Thus, turnaround will be accomplished when the transfer agent "completes all acts necessary to cancel the certificate or certificates presented for transfer and to issue a new certificate or certificates, and the item is made available to an outside registrar." Exchange Act Rule 17Ad-1(c)(2), 17 CFR 240.17Ad-1(c)(2).

342 If the presentor has given special instructions, the timing is measured differently. See Exchange Act Rule 17Ad-1(d), 17 CFR 240.17Ad-1(d).

343 See Exchange Act Rule 17Ad-1(c)(1), 17 CFR 240.17Ad-1(c)(1).

Upon issuing the new security to the transferee, the transfer agent must credit the securities account of the transferee receiving the new security. This is accomplished by posting to the master securityholder file all of the certificate detail information set forth in Rule 17Ad-9(a), generally within five business days.[344]

In the case of an uncertificated security, there is no certificate to cancel and no new certificate to be issued. Under Rule 17Ad-1(d), posting the new ownership information to the master securityholder file changes the ownership information of the securities account and "completes registration of change in ownership of all or a portion of those securities."

Transfer agents are also responsible for countersigning securities upon issuance, which provides critical authentication of a security by an independent, outside actor. In general, "countersigning" means a signature added to a document previously signed by another person for authentication or confirmation. The second signature confirms the first signature, and the two signatures together are intended to show the certificate's legitimacy. In the case of certificated securities, the first signer is typically an officer of the issuing corporation, and the countersigner is typically an independent officer of the issuer's transfer agent. The procedures involved in countersignature of physical certificates are not mandated by the Exchange Act,[345] but are

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344 See Exchange Act Rules 17Ad-9(a), 17Ad-10, 17 CFR 240.17Ad-9(a), 17Ad-10. We note that, in the case of a cancellation, which involves a "debit" to the master securityholder file under Rule 17Ad-9, the cancellation date would be the only portion of the "certificate detail" required to be posted to the master securityholder file. See Exchange Act Rule 17Ad-9, 17 CFR 240.17Ad-9.

345 As discussed in Section IV.A, the Exchange Act, however, includes countersigning certificates as one element of the definition of transfer agent in Section 3(a)(25).

generally the product of other sources of law that either require them or otherwise address them in certain respects, such as by permitting them to be made by facsimile.[346]

In the case of DRS shares, where no certificate exists, an investor has the option of having his or her ownership of securities registered in book-entry form on the issuer's records or on the books of the issuer's transfer agent, and in either case the investor receives a "statement of ownership."[347] In either event, it is an important verification step in the issuance of a security and highlights the important role that transfer agents play as intermediaries for the public interest.

*4. Corporate Actions and Related Services: Rules 17Ad-1, 6, 10, 12, and 13*

A corporate action is an event in the life of a security, typically instigated by the issuer, which affects a position in that security.[348] Examples of common corporate actions include changes that affect capital structure, such as a merger or acquisition, and distributions to securityholders, such as a dividend distribution or principal or interest payment on a debt security. Corporate actions may also include bankruptcy or liquidation proceedings, conversions, warrants, exchange offers, subscription rights, tender offers, and other events.[349] Generally, corporate actions can be divided into two broad categories: mandatory and voluntary (sometimes referred to as "elective.") Mandatory corporate actions usually affect all

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346 See, e.g., Del. Code Ann. tit. 8 § 158 ("Any or all the signatures on the certificate may be a facsimile.").

347 See Concept Release, Transfer Agents Operating Direct Registration System, Exchange Act Release No. 35038 (Dec. 1, 1994), 59 FR 63652 (Dec. 8, 1994) ("Investors who choose to participate in a direct registration system could have their securities registered in book-entry form directly on the books of the issuer and could receive a statement of ownership in lieu of a securities certificate.").

348 Simmons and Dalgleish, Corporate Actions: A Guide to Securities Event Management 3-5 (2006).

349 See id. (categorizing major types of corporate actions).

securityholders equally and the securityholder does not have different options from which to choose; voluntary corporate actions usually allow securityholders to choose among one or more different elections they can make.

Transfer agents may perform a variety of roles and provide a variety of services, depending on the type and nature of the corporate action. For example, a transfer agent may take on the role of exchange agent in a mandatory corporate action, such as a stock-for-stock merger or a cash-for-stock merger. In a stock-for-stock merger the exchange agent might facilitate the surrender of outstanding securities for new securities, and in a cash-for-stock merger the exchange agent might facilitate the exchange of outstanding securities for cash.

In both of these examples, under Rule 17Ad-10, the transfer agent performing exchange agent services generally must update the master securityholder file with certificate details within five business days. But because the transfer associated with some of the most common corporate actions qualify as non-routine items under Rule 17Ad-1, including transfers "in connection with a reorganization, tender offer, exchange, redemption, or liquidation,"[350] the general three business day deadline for turnaround of routine items under Rule 17Ad-2 may not apply. However, if a transfer agent makes a determination that a transfer does fall within Rule 17Ad-1(i)(5) and therefore is non-routine, Rule 17Ad-6(a)(11) requires the transfer agent to maintain records documenting the basis for this determination.[351] Other aspects of the processing of the

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350 Exchange Act Rule 17Ad-1(i)(5), 17 CFR 240.17Ad-1(i)(5).

351 A large portion of specific records that transfer agents are required to maintain under Rule 17Ad-6 and to retain for different periods of time under Rule 17Ad-7 relate to: (i) the classification of an item as routine or non-routine; (ii) tracking the compliance of the transfer agent with the performance standards for turnaround of routine items under Rule 17Ad-2(a); and (iii) the performance standards for processing of all items pursuant to Rule 17Ad-2(b).

corporate action may cause the corporate action to be classified as non-routine as well. For example, if a transfer associated with a corporate action involves a need to review "explanations, or opinions of counsel before transfer may be effected," requires "review of supporting documentation" other than routine documentation, or includes a warrant, right, or convertible security "presented for exercise or conversion" or "presented for transfer...within five business days" before expiry it will be considered non-routine under Rule 17Ad-1.[352]

Voluntary corporate actions, which permit securityholders to choose among different options, may result in the need for additional tasks and systems for transfer agents to process them. For example, in addition to the ordinary recordkeeping tasks, the transfer agent may be responsible for monitoring whether elections have been made by deadlines and for tracking such elections.

In addition to the examples discussed above, transfer agent roles in connection with corporate actions may also include serving as: (i) tender agent, when the transfer agent collects shares surrendered from securityholders and makes payments for the shares at a predetermined price; (ii) exchange agent, when the transfer agent collects shares surrendered from securityholders and issues, registers, and/or distributes shares of the bidding company's securities as compensation for tendered securities of the subject company; (iii) subscription agent, when the transfer agent invites existing equity securityholders of an issuer to subscribe to a new issuance of additional debt or equity of the issuer; (iv) conversion agent, for example when the transfer agent converts debt securities into equity securities; and (v) escrow agent,

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352 Exchange Act Rule 17Ad-1(i), 17 CFR 17Ad-1(i).

when the transfer agent holds an asset on behalf of one party for delivery to another party upon specified conditions or events.

Finally, transfer agents providing corporate action services may be subject to Rule 17Ad-12 and 17Ad-13, regarding safeguarding requirements for funds and securities and an annual audit of internal control of safeguarding procedures. As discussed above, corporate actions may involve transfer agents making distributions on behalf of issuers to securityholders of cash and stock dividends as well as principal and interest payments on debt securities. Rule 17Ad-12(a) requires that:

> Any registered transfer agent that has custody or possession of any funds or securities related to its transfer agent activities shall assure that: (1) All such securities are held in safekeeping and are handled, in light of all facts and circumstances, in a manner reasonably free from risk of theft, loss or destruction…; and (2) All such funds are protected, in light of all facts and circumstances, against misuse.

Rule 17Ad-13 requires every registered transfer agent to file an annual report with the Commission and the transfer agent's ARA prepared by an independent accountant concerning the transfer agent's system of internal accounting controls and procedures for, among other things, safeguarding of securities and funds. Specifically, Rule 17Ad-13(a)(2)(iii) requires the report to cover "[t]ransferring record ownership as a result of corporate actions" and Rule 17Ad-13(a)(2)(iv) requires the report to cover "[d]ividend disbursement or interest paying-agent activities."

### B. Annual Meeting, Proxy-Related Services, and Securityholder Services and Communications

One of the key rights of securityholders is the right to vote their shares on important matters that affect the companies they own. Pursuant to state corporate law, registered securityholders may either attend a meeting to vote shares in person or authorize an agent to act as their "proxy" at the meeting to vote their shares pursuant to their voting instructions.[353] Because most securityholders do not physically attend public company securityholder meetings, the corporate proxy is the principal means by which they exercise their voting rights.

The process in the United States for distributing proxy materials and soliciting, tabulating, and verifying votes by securityholders is complex, especially with respect to beneficial securityholders.[354] Most corporate issuers and securities intermediaries such as banks and brokers rely on a proxy service firm to perform these functions, which may include distributing and forwarding the proxy materials and collecting and tabulating voting instructions. Alternatively, some issuers choose to engage their transfer agents for certain parts of the proxy distribution process, such as printing and distributing proxy materials either directly to registered securityholders or to intermediaries, which will then distribute them to beneficial owners either through the mail or electronically.[355] Providing these services may be a natural extension of a transfer agent's core functions because most transfer agents will already possess and maintain the master securityholder file listing the issuer's registered securityholders, will have the infrastructure in place to communicate with registered securityholders, and will be in a position

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353 See Del. Code Ann. tit. 8, §212 (b), (c). A full discussion of the proxy system is beyond the scope. For more information on the proxy system, see Proxy Concept Release, supra note 112.

354 Beneficial owners holding securities in street name are not technically entitled to vote shares or grant proxy authority. Rather, the voting rights reside with Cede & Co. as the record owner of all street name shares. However, because Cede & Co.'s role is only that of nominee for DTC as custodian and it has no beneficial interest in the shares, mechanisms have been developed in order to pass the legal rights it holds as the record owner to the beneficial owners, enabling them to vote. For a more comprehensive discussion of these and other issues relating to the U.S. proxy and indirect holding systems, see Proxy Concept Release, supra note 112.

355 See, e.g., Broadridge Annual Report 2015 (2015), available at http://www.broadridge-ir.com/~/media/Files/B/Broadridge-IR/annual-reports/ar-2015.pdf.

to reconcile the identity of registered voters and the number of votes against the official records of the issuer.[356] Typical transfer agent proxy services might include mailing or electronically transmitting notices of meetings,[357] proxy statements, and proxy cards[358] to securityholders.

In addition, under many state statutes, an issuer must appoint a vote tabulator (sometimes referred to as the "inspector of elections" or "proxy tabulator") to collect and tabulate the proxy votes as well as ballot votes cast in person by registered owners at a securityholder meeting.[359] As with proxy distribution services, some issuers hire their transfer agent to create sophisticated voting platforms for securityholders or to act as the vote tabulator.[360] The vote tabulator is ultimately responsible for determining whether shares are represented at the meeting, the validity of proxies received, and tallying the votes.[361] The tabulator must determine that the correct

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356 See Proxy Concept Release, supra note 112. See Proxy Tabulation and Solicitation, AST, http://www.amstock.com/corporate/corporate_proxy.asp (last visited November 20, 2015).

357 See, e.g., Del. Code Ann. tit. 8, § 222 (2001). See also Del. Code Ann. tit. 8, § 232 (2001).

358 In cases where the issuer is relying upon the notice and access model of proxy statement distribution, the proxy card must be mailed even if the proxy statement is not mailed by the issuer. See Final Rule: Internet Availability of Proxy Materials, Exchange Act Release No. 55146, 10 (Jan. 22, 2007), 72 FR 4148 (Jan. 29, 2007).

359 See, e.g., Del. Code Ann. tit. 8, § 231(a)-(c)(2001) (inspectors must be appointed in advance of all stockholder meetings of publicly held corporations and have responsibility for ascertaining the number of shares outstanding and the voting power of each, determining the shares represented at the meeting and the validity of proxies and ballots, counting all votes and ballots, creating and retaining a record of the disposition of any challenges made to any determination of the inspectors, and certifying their determination of the number of shares represented at the meeting and the count of all votes and ballots).

360 Sometimes the issuer will hire an independent third party other than the transfer agent to perform the proxy tabulation function, such as to certify important votes. In such cases, the issuer or its transfer agent typically will provide the third party vote tabulator with the list of record owners so the vote tabulator can make this determination. Additionally, in contested votes, the issuer will commonly retain an independent inspector to count the proxies. See, e.g., www.ivsassociates.com/html/index2.htm.

361 See, e.g., Del. Code Ann. tit. 8, § 231(2001); see also Marcel Kahan & Edward B. Rock, The Hanging Chads of Corporate Voting, 96 Geo. L.J. 1227, 1235 (2008) ("Where more than one valid proxy is given for a share, the later proxy revokes the earlier proxy. Determining the validity of proxies and the tally of votes is the responsibility of the inspector, appointed by the corporation."), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1007065.

number of votes has been submitted by each registered owner and determine that proxies submitted by securities intermediaries that are not registered owners are reconciled with DTC's securities position listing for that intermediary (i.e., determining that the number of nominee shares voted equals the number of shares that DTC indicates are held in nominee name).[362] Although the Commission does regulate transfer agents, which often serve as vote tabulators, it does not regulate the function of tabulating proxies by transfer agents.

All transfer agents also provide some level of securityholder communications services. The level of services may depend on the type or size of the issuer, but at a minimum, most transfer agents facilitate the mailing of quarterly and annual statements with details of holdings, transaction confirmations, and letters or communications confirming other transactions, such as address-change confirmations. Many transfer agents also provide tax reporting services, including sending tax forms such as W-9, W-8BEN, 1099-DIV, and 1099-B.

Most transfer agents also receive and respond to inquiries and requests by securityholders and non-securityholders,[363] often through interactive websites, call centers, and the like. Requests may involve a transfer (for example, a gift of fund shares from one family member to another) or a change in the securityholder's account, such as an address change or different election regarding dividend reinvestment. For transfer agents to open-end mutual funds, transfers may involve a purchase (i.e., a "subscription") or sale (i.e., a "redemption") of the

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362 See Proxy Concept Release, supra note 112. See, e.g., http://www.amstock.com/corporate/corporate_proxy.asp.

363 As discussed supra Section IV.A, several Commission rules address securityholder inquiries. See Exchange Act Rule 17Ad-5, 17 CFR 240.17Ad-5 (written inquiries and requests); Exchange Act Rules 17Ad-6, 7, 17 U.S.C. 240.17Ad-6, 7 (recordkeeping and retention requirements regarding inquiries and requests).

fund's shares.[364] Transfer agents may receive inquiries as well, which may not require processing a transaction or account change, but may involve merely answering questions about the securityholder's account or regarding the issuer generally.[365] Requests and inquiries are transmitted to transfer agents through various methods, including by telephone, mail, facsimile, email, internet, mobile communication device, and in-person. The predominance of telephone and other forms of electronic communication as favored methods for securityholders to communicate with issuers and their transfer agents, including the use of standardized protocols over the internet, means that managing sizable call centers and other customer service departments, with many representatives fielding calls and other message-traffic, has become a critical aspect of the transfer agent-issuer relationship.

One aspect of these securityholder services is lost certificate replacement. If a securityholder loses a certificate, the old certificate must be cancelled and new shares issued, either in certificated or book-entry form. Transfer agents facilitate this process by processing the request and replacing the lost or missing certificate. Generally, the securityholder will be required to fill out a declaration, affidavit, or other form with identifying information and a description of the circumstances giving rise to the loss and pay a fee to the transfer agent for processing the request. Most transfer agents will also require a surety bond to indemnify the issuer and transfer agent against any potential losses in connection with the missing or replacement certificate in the event it is later presented for transfer or conversion. The transfer

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364 For additional discussion of "transfers," see supra Section IV.A.2.

365 Inquiries about the securityholder's account may relate, for example, to matters such as dividend reinvestment or other account options.

agent will then report the lost or missing certificate to SIC pursuant to Rule 17f-1, as described above in Section II.B.

C. Regulatory Compliance and Reporting

Although not addressed directly in the transfer agent rules, most transfer agents today provide assistance with issuers' obligations to comply with various state and federal laws, including the federal securities laws, because many issuer compliance obligations fall directly into areas in which the transfer agent is already providing services to the issuer. For example, transfer agents may use their mailing and fulfillment services to help issuers meet their obligations to deliver certain documents to securityholders.[366] Transfer agents may also use their existing recordkeeping capabilities to help issuers meet obligations regarding disclosure of securityholders owning more than a certain threshold of ownership.[367] Further, investment company issuers subject to anti-money laundering responsibilities under federal law may rely on transfer agents to assist their compliance since this function is closely related to the new account processing services and securityholder recordkeeping services transfer agents provide to these issuers.

Finally, transfer agents spend a much greater amount of time and resources on assisting issuers with their escheatment obligations under state law than they have done historically. Escheatment is the process of transferring abandoned property to the state or territory. All 50

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366 See, e.g., Exchange Act Rule 14c-3, 17 CFR 240.14c-3 (annual report to be furnished securityholders); Investment Company Act Rule 30e-1, 17 CFR 270.30e-1 (reports to stockholders of management companies); Investment Company Act Rule 30e-2, 17 CFR 270.30e-2 (reports to shareholders of unit investment trusts).

367 See, e.g., SEC Form N-1A, Item 18 (Control Persons and Principal Holders of Securities), SEC Form 10-K, Item 12 (Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters).

states, Washington, DC, Puerto Rico, and all U.S. territories have abandoned property laws which apply to any type of holding, including stock and associated payments made to securityholders, such as dividend payments. When a property owner fails to demonstrate ownership of property—for example, by not cashing dividend checks or responding to mailings—for a period of time, that property is deemed abandoned and is turned over to the state. The state then converts the property to cash within 30 days to two years. A securityholder who is holding securities that have been escheated will only be able to reclaim the sale price the state received, without interest, not the securities themselves.[368]

Pursuant to these abandoned property laws, issuers, through their transfer agents, are required to report when property is deemed to be abandoned based on the applicable abandoned property statute. Thus, issuers are required to file abandoned property reports annually with the individual states and U.S. territories, and to turn over abandoned property according to individual state laws. Failure to file on time can result in significant penalties and interest fees per year.

Transfer agents typically assist issuers with initial escheatment filings with the states in which securityholders have abandoned property, and then an annual filing every year after that with those states. In addition to fulfilling reporting requirements, typical activities may include attempted communications with the securityholder, maintaining up-to-date knowledge of federal and state escheatment requirements, proper accounting and handling of property prior to escheatment, and appropriate transfer of property.

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368 See, e.g., Cal. Civ. Proc. Code §§ 1500 et. seq. (California's requirements); Tex. Prop. Code Ann. §§ 72-76 (Texas' requirements). We note also that Rule 17Ad-17 requires transfer agents to make certain efforts to locate lost securityholders.

## VI. ADVANCE NOTICE OF PROPOSED RULEMAKING

An advance notice of proposed rulemaking provides notice to the public that the agency is considering rulemaking in an area so that the public can participate in the formulation of potential future rules and can help shape a future notice of proposed rulemaking. Through this advance notice of proposed rulemaking, the Commission is requesting comment on specific areas and topics with respect to transfer agent regulation. As noted earlier, the Commission then intends to review comments and to then propose new rules, as soon as is practicable, either individually or in groups or phases to expedite the rulemaking process.

In particular, based on our current understanding of transfer agents and their functions, the Commission intends to propose new or amended rules to: (1) expand the scope of information collected by Forms TA-1 and TA-2 and capture all such information in a structured, electronic format as needed to enhance aggregation, comparison, and analysis; (2) require that any arrangement for transfer agent services between a registered transfer agent and an issuer be set forth in a written agreement that addresses topics such as the transfer agent services to be provided, the fee schedule, and requirements for the handing over of transfer agent records to the successor transfer agent; (3) enhance transfer agents' requirements for the safeguarding of issuer and securityholder funds and securities; (4) apply an anti-fraud provision to specific activities of transfer agents; (5) require transfer agents to establish business continuity and disaster recovery plans; (6) require transfer agents to establish basic procedures regarding the use of information technology, including methods of safeguarding personally identifiable information; (7) revise the recordkeeping requirements to more fully capture the scope of a transfer agent's business activities; and (8) conform and update various terms and definitions to reflect modern systems and usage, as well as the elimination of obsolete rules, such as those addressing Y2K issues.

In addition to the specific requests for comments in each section below, we also seek comment on the following:

1. For all regulatory issues discussed below, please comment on the need for revisions to the current regulatory framework, including the proposals described above, and the benefits they could provide for transfer agents, investors, issuers, and the capital markets. In particular, please comment on whether the proposals will increase the prompt and accurate clearance and settlement of securities transactions or have other benefits, such as reducing the potential for fraudulent activity. Please also comment on the potential effects on efficiency, competition, and capital formation of potential revisions to the current regulatory framework, if any. If you wish to comment on such potential benefits and effects, please explain the implications of any impact on competition, economic efficiency, capital formation, and the behavior of affected market participants, including transfer agents, issuers, and investors. For each benefit, effect and implication, provide supporting evidence and/or explain how such evidence may be obtained. Also please describe the current competitive landscape for each such affected transfer agent service. For example, to the extent possible, provide evidence on the identities of current providers, their market shares, their ease or cost of entry and exit, the cost to issuers of switching transfer agents, and the frequency of any such switching. Are there any other issues that are not discussed below but that should be addressed? If so, what are they and how should they be addressed?

2. For all regulatory issues discussed below, please comment on any potential interplay between applicable SRO rules and the potential revisions to the current regulatory framework for transfer agents discussed herein, including any potential conflicts that should be considered or resolved. Please provide a full explanation.

3. Are there specific areas where transfer agents need additional guidance or regulatory clarity regarding the applicability of current rules? How could such guidance best be provided? Would rule modification, staff guidance, or an industry roundtable be helpful?

4. Should the Commission prioritize certain of the proposed rule changes discussed in this Advance Notice of Proposed Rulemaking over others? If so, which ones and why? Are there other rule changes besides those discussed in this Advance Notice of Proposed Rulemaking that the Commission should prioritize? Please explain.

## A. Registration and Annual Reporting Requirements

As discussed generally above in Section IV.A, Forms TA-1 and TA-2 are used to: (i) help regulators, issuers, investors, and other interested parties determine whether a transfer agent is and will continue to be able to perform its functions properly; (ii) help regulators, issuers, investors, and other interested parties determine the nature of the business conducted by a particular transfer agent; (iii) permit the Commission to effectively target its transfer agent inspection program, including assisting examiners in preparing for and conducting transfer agent examinations; (iv) monitor transfer agent activity generally; (v) enable Commission staff to evaluate particular burdens and benefits that would be placed on the industry in potential rulemaking endeavors; and (vi) assist the Commission and Commission staff in assuring that rules are properly focused and refined.[369] Form TA-1 was developed and first adopted in 1975[370] and Form TA-2 was first adopted in 1986.[371] The information provided by these forms serves, among others, the vital regulatory goals of informing the Commission's oversight and examination programs and informing the public about the nature and scope of transfer agents' activities. The Commissions believes the usefulness and utility of both forms in serving these important goals might be enhanced if they captured certain additional information, such as financial information, potential conflicts of interest, and detailed information about the types of services being provided and to whom.

To assure that Forms TA-1 and TA-2 continue to serve the regulatory goals described above, especially in light of the expanded scope of transfer agents' activities as discussed throughout this release, the Commission intends to propose amendments to the forms to include

369 See, e.g., Adoption of Revised Transfer Agent Forms and Related Rules, supra note 161.

370 See Notice of Adoption of Rule 17Ac2-1 and Related Form TA-1 under the Securities Exchange Act of 1934 Providing for the Registration of Transfer Agents for which the Commission is the Appropriate Regulatory Agency, Exchange Act Release No. 11759 (Oct. 22, 1975), 40 FR 51181 (Nov. 4, 1975).

371 See Adoption of Revised Transfer Agent Forms and Related Rules, supra note 161.

disclosure requirements with respect to certain financial information, such as the financial reports discussed below in Section VI.C (e.g., statements of financial condition, income, and cash flows), all direct or indirect conflicts of interest, the issuers and securities for which a transfer agent is providing transfer agent and other services, and the specific services being provided or expected to be provided for each issuer or security, regardless of the nature of those services. These anticipated amendments are intended to facilitate disclosure that is more closely targeted at risks associated with contemporary transfer agent activities.

A requirement that transfer agents and their officers and directors disclose any past or present affiliation with issuers serviced by, or broker-dealers affiliated with, the transfer agent could reveal instances where a transfer agent or its officers and directors have an ownership interest in such issuers and broker-dealers, including details about how the interest was obtained. Such disclosures could provide transparency about the existence of possible financial interests or other potential conflicts of interest that could incentivize a transfer agent to facilitate an improper transfer or engage in other improper conduct.

Financial disclosures may include annual financial statements using a data-tagged format, such as XBRL, broken out by the asset classes serviced by the transfer agent, such as equities, debt, and investment companies.

The Commission seeks comment on the following:

5. Should the Commission require any of the registration and disclosure items discussed above? Why or why not? Should the Commission consider other requirements? Please explain. What would be the benefits and costs associated with any such requirements? Please provide empirical data. If the Commission were to require transfer agents to disclose financial information, what information should be required, and why? Would requiring such information to be disclosed on Forms TA-1 and/or TA-2 be an effective and appropriate measure? What would be the benefits and costs associated with any such requirement?

6. Should the Commission consider amending the registration process to allow for

the issuance of an order approving a transfer agent's TA-1 application before that application becomes effective, rather than having such applications become effective automatically after 30 days? Should the Commission consider making certain findings before approving a transfer agent's application? If so, what should those findings be? Should the Commission impose threshold requirements that transfer agents must satisfy before their applications can become effective? If so, what would they be?

7. The Commission intends to propose to require transfer agents to submit annual financial statements. Should these statements be required to be audited? Why or why not?

8. Should the Commission require that annual financial statements be submitted using a data-tagged format such as XML or XBRL? Would such a requirement require changes to the U.S. GAAP Taxonomy in order to capture the information included in transfer agents' financial statements? Why or why not? Should some other electronic format be required or permitted?

9. Does the receipt of securities as payment for services create conflicts of interest for transfer agents, and if so, should the Commission require that such payments be disclosed? The Commission intends to propose to amend Forms TA-1 and/or TA-2 to require transfer agents to disclose all actual and potential conflicts of interest. Should it do so? Why or why not? Should the Commission provide any guidance as to what constitutes a conflict of interest? Why or why not? Has the proliferation of the types of services offered by transfer agents in recent years created new conflicts of interest? How might transfer agents' conflicts of interest differ depending upon whether the transfer agent is paid by the issuer, the shareholder, or some combination thereof? Is disclosure of conflicts of interest a sufficient safeguard for investors? Should the Commission ban certain conflicts of interest entirely? For example, should the Commission prohibit transfer agents from having certain affiliations with issuers or broker-dealers, or from providing certain services if they have such affiliations? Please provide a full explanation.

10. Should the Commission amend Forms TA-1 and/or TA-2 to require transfer agents to disclose information regarding the fees imposed or charged by the transfer agent for various services or activities? If so, what type of information or level of detail should be required? Should the Commission require that fee disclosures be standardized to facilitate comparison? Should fees charged to both issuers and directly to shareholders be required to be disclosed? Please provide a full explanation.

11. To increase the ability of the Commission to monitor trends, gather data and address emerging regulatory issues, should the Commission require registered transfer agents to file material contracts with the Commission as exhibits to Form TA-2? What costs, benefits and burdens, if any, would this create for issuers or transfer agents? Should the Commission establish a materiality threshold or

provide guidance on materiality were it to propose such a rule? Please provide a full explanation.

12. Should the Commission amend Forms TA-1 and/or TA-2 beyond any changes discussed above? If so, what amendments should the Commission consider in making that determination and why? Please provide a full explanation.

13. What costs, benefits, and burdens, if any, would the potential requirements discussed above create for issuers or transfer agents?

B. Written Agreements Between Transfer Agents and Issuers

Transfer agency agreements between transfer agents and issuers are mainly governed by state contract law.[372] It is the Commission staff's understanding, based on information collected during examination of registered transfer agents and review of a number of written agreements between transfer agents and issuers, that many transfer agents enter into written contracts with their issuers that cover some or all of the following subjects: (1) the services to be provided by the transfer agent and performance metrics and standards; (2) the responsibilities of the parties; (3) the duration of the agreement, including termination fees; (4) the fees and terms of payment; (5) the terms that govern termination of the agreement; (6) the disposition of securityholder records after the agreement's termination; (7) the use and protection of data, such as privacy and business continuity requirements; and (8) indemnification.

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[372] At present, no UCC or Commission rule requires that transfer agent service agreements with issuers be set down in writing or governs the terms of such agreements. Rule 17Ad-16 requires a registered transfer agent to notify an appropriate qualified registered securities depository under certain circumstances, including when the transfer agent assumes or ceases transfer agent services for an issuer, but does not address the terms of transfer agent service agreements with issuers nor require that they be set forth in writing. Exchange Act Rule 17Ad-16, 17 CFR 240.17Ad-16. See also Adopting Release for Rule 17Ad-16, supra note 147.

However, some transfer agents, often smaller transfer agents that may primarily service smaller issuers, may not document their arrangements with issuers in a written agreement or, even if they do enter into a written agreement, it may not cover all of the subjects identified above. Based on the Commission staff's experience administering the Commission's transfer agent rules and examination program, it appears that such undocumented or under-documented arrangements may be more likely than written agreements to lead to protracted disputes, especially with respect to: (1) the duration of the arrangement; (2) the conditions of the arrangement's termination; (3) the disposition of the securityholder records after termination or notice of termination; and (4) the fees charged by the transfer agent. Such disputes may interfere with the operations of the markets and the protection of investors by disrupting or otherwise hindering transfer agent processing, recordkeeping, and safeguarding. For example, it is the Commission staff's understanding that some transfer agents, after having been terminated by the issuer, have substantially delayed the handing over of securityholder records to successor transfer agents by demanding that the issuer pay a substantial "termination" fee before the transfer agent would agree to hand over the securityholder records it had been maintaining, even though the issuer claimed there was no written agreement in place or it had otherwise not agreed to such a fee.[373] In such cases, the issuer may be unable to retain a new transfer agent if the old transfer agent will not make the records available to the new transfer agent. The inability to retain a new transfer agent could lead to inaccuracies in the master securityholder file and other

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373 It is the Commission staff's understanding that typical termination fees may range from about $1,000 to $5,000, though disputes like those described herein may involve a transfer agent's demand for fees as high as $30,000.

records or impede trading in the issuer's securities. Commission staff is also aware of instances in which a termination dispute between an issuer and a transfer agent has resulted in two transfer agents each maintaining separate records, which could be inconsistent with each other.

The Commission believes that the existence of a written agreement that describes the ongoing relationship under which a transfer agent and an issuer will operate, including the terms under which the agreement between them may be terminated, could help to avoid such disputes, including disputes over agreed-upon fees, and could help ensure the timely and appropriate turnover of an issuer's shareholder records upon the termination of the written agreements. If the relationship between an issuer and a transfer agent is terminated and the issuer engages a new transfer agent, it is essential to the issuer, its securityholders, and the market participants who may seek to trade the issuer's securities, that the issuer's records are promptly delivered to the new transfer agent to provide an orderly continuity of services.

Among the issuer's records and related documents typically in the possession of its transfer agent are: (1) the master securityholder file with the names and addresses of current securityholders and the amount of securities owned by each holder;[374] (2) the control book showing the total units outstanding of each securities issue;[375] (3) the logs showing items transferred and processed for each issue; (4) the records of each issue's distributions (e.g., interest and dividends) to securityholders; (5) an inventory of blank (unissued) securities

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374 See Exchange Act Rule 17Ad-9(b), 17 CFR 240.17Ad-9(b).

375 See Exchange Act Rule 17Ad-9(d), 17 CFR 240.17Ad-9(d) (defining "control book").

certificates for each issue; and (6) the records of cancelled securities certificates for each issue.[376] Such records are critical to issuers' routine operations as a stock corporation and to ensuring that investors' rights are protected. Without these records it would be challenging to: (1) establish the identities of its own securityholders or the number of units of securities each investor holds; (2) determine whether the number of its shares outstanding is within the bounds of its corporate charter or whether there has been an overissuance; (3) distribute interest and dividend payments to its investors; or (4) provide to investors periodic reports and proxy statements.

The Commission therefore intends to propose amendments to the transfer agent rules to require that any arrangement for transfer agent services between a registered transfer agent and an issuer be set forth in a written agreement that covers certain basic topics, such as the transfer agent services to be provided, the terms of payment and fees to be imposed, particularly any termination fees, and requirements for the turnover of transfer agent records to the successor transfer agent. The Commission further intends to propose new or amended rules requiring transfer agents to pass through certain records to newly appointed or successor transfer agents in a prompt, complete, and uniform manner.

The Commission seeks comment on the following:

14. Should the Commission require that any arrangement for transfer agent services between a registered transfer agent and an issuer be set forth in a written agreement? Why or why not? What are the alternative means of achieving similar objectives, and are they as effective or efficient? If the Commission were to require a written agreement, should it cover certain topics? If so, what topics? For any such provisions or topics, are there asymmetries in information or other

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376 See Exchange Act Rule 17Ad-19, 17 CFR 240.17Ad-19 (cancellation of certificates); Exchange Act Rules 17Ad-6(c), 7(d), 17 C.F.R. 240.17Ad-6(c), 7(d) (requiring that such cancelled certificates "be maintained for a period of not less than six years.").

areas between transfer agents and issuers that the Commission should consider in connection with such contractual provisions? For what types of transfer agents, or in what types of such relationships, do these asymmetries most frequently arise, and where are they most acute? Please provide a full explanation and supporting evidence.

15. How are fees set out in transfer agent agreements today? Do issuers find it difficult to fully understand the fee structures offered by transfer agents, and how do those fee structures work in practice? Should the Commission require that all fee arrangements between an issuer and a transfer agent be set forth and specified in a written agreement? Why or why not? Should the Commission require that transfer agents disclose their fee arrangements in their filings with the Commission? If so, should transfer agents be required to utilize a standardized framework or terminology when disclosing their fee structures? Should the Commission exempt fees which may be negotiated on a case-by-case basis, such as corporate action fees? Why or why not? Would requiring disclosure of fees affect competition, or the form of competition, among transfer agents or between transfer agents and other entities? Please provide a full explanation and supporting evidence.

16. Currently, transfer agents are not required by rule to pass through specified records to successor transfer agents. Are issuers or transfer agents aware of instances where records have not been passed from one agent to the next, or agents have not done so in a prompt manner? Are commenters aware of disputes between transfer agents and their issuer clients or successor transfer agents with respect to the transfer of records to a successor transfer agent? How was the situation resolved? Have transfer agents demanded previously undisclosed termination fees, or fees inconsistent with what those parties previously agreed to, in exchange for turning over records to a successor? Would the anticipated proposed rules described above help avoid or resolve any disputes between transfer agents and issuers or successor-transfer agents with respect to the transfer of records? Please provide a full explanation and supporting evidence.

17. What costs, benefits, and burdens, if any, would a written agreement create for issuers or transfer agents?

C. <u>Safeguarding Funds and Securities</u>

Because transfer agents already facilitate securities transfers and maintain securityholder records, approximately one-third of them are engaged by issuers to provide administrative, recordkeeping, and processing services related to the distribution of cash and stock dividends, bond principal and interest, mutual fund redemptions, and other payments to securityholders.[377] These services, which are generally referred to in this release as "paying agent" services,[378] often require the transfer agent to receive and accept funds or securities from issuers or securityholders and hold them for periods generally ranging from less than one day to 30 days before distributing the funds or securities to the intended recipients.[379] Transfer agents' activities with respect to paying agent services are significant. In 2014, transfer agents distributed over $2.4 trillion in securityholder dividends, bond principal and interest, and mutual fund redemption payments.[380]

Additionally, the Commission's staff understands that transfer agents may hold residual funds from thousands to millions of dollars and securities for long periods of time ranging from over a month to several years, before distributing the funds or securities either to the intended recipients or escheating the funds or securities to a state or territory.[381] Residual funds or

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377 This data is based on transfer agent annual reports filed with the Commission on Form TA-2 on or before March 31, 2015, which are publicly available once filed. See generally, Exchange Act Rule 17Ac2-2(a), 17 CFR 240.17Ac2-2(a); SEC Form TA-2, 17 CFR 249b.102.

378 Entities other than transfer agents may also provide paying agent services. For example, recently amended Rule 17Ad-17(c)(2) defines "paying agent" to include "any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian, or any other person that accepts payments from the issuer of a security and distributes the payments to the holders of the security." 17 CFR 240.17Ad-17(c)(2). See supra Section IV.A.4 for additional discussion of Rule 17Ad-17.

379 Certain corporate actions may require the transfer agent to hold funds for extended periods of time beyond 30 days. For example, where a tender offer is extended beyond 30 days, the transfer agent may maintain possession or control over investor funds until the offer expires. The Commission notes that when transfer agents have custody of funds or securities, they have a duty to safeguard that property. See Exchange Act Rule 17Ad-12, 17 CFR 240.17Ad-12.

380 This figure is based on transfer agent annual reports filed with the Commission on Form TA-2 under the Exchange Act on or before Mar. 31, 2015, which are publicly available once filed. See generally, Exchange Act Rule 17Ac2-2(a), 17 CFR 240.17Ac2-2(a); SEC Form TA-2, 17 CFR 249b.102.

381 As noted above in Section V.C, when a property owner fails to demonstrate ownership of property for a specified period of time by, for example, cashing a dividend check, that property will likely be deemed by the relevant state to be abandoned and will be escheated to the state's unclaimed property administrator

securities include those which cannot be successfully delivered to the intended recipient because the transfer agent has lost contact with the intended recipient (e.g., lost securityholder funds),[382] as well as those which are transmitted or delivered, but the intended recipient nonetheless does not demonstrate ownership of the property (e.g., unresponsive payee funds, which may ultimately be escheated).[383]

As demonstrated by the Paperwork Crisis, the financial crisis of 2008, the 2012 flooding of the DTCC securities vault in New York during Superstorm Sandy,[384] and many other incidents, the safe, accurate, and efficient delivery of funds and securities, whether in certificated or uncertificated form, is vital to the integrity and smooth functioning of the National C&S System. Given their significant role in providing paying agent and custody services for funds and securities,[385] and the risk of loss from fraud, theft, or other misappropriation,[386] the funds

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pursuant to the state's applicable escheatment laws. See, e.g., Adopting Release for 17Ad-17 Amendments, supra note 274.

382 See Exchange Act Rule 17Ad-17(b)(2), 17 CFR 240.17Ad-17(b)(2) (defining "lost securityholder"). As noted above in Section IV.A.4, the requirement to conduct database searches for lost securityholders has been extended to brokers and dealers. See Adopting Release for 17Ad-17 Amendments, supra note 274.

383 See Exchange Act Rule 17Ad-17(c)(3), 17 CFR 240.17ad-17(c)(3) (defining "unresponsive payee"). Rule 17Ad-17(c)(1) generally requires paying agents to provide within certain time periods written notification to each unresponsive payee that the securityholder has been sent a check (or checks) that has not yet been negotiated. Exchange Act Rule 17Ad-17(c)(1), 17 CFR 240.17Ad-17(c)(1).

384 See DTCC 2013 Annual Report (2013), available at http://www.dtcc.com/annuals/2013/index.php (discussing DTC vault flood and security certificate recovery process after Superstorm Sandy).

385 See supra note 380 (data on distributions made in 2014 by registered transfer agents on behalf of issuers).

386 See, e.g., SEC v. Robert G. Pearson and Illinois Stock Transfer Company, Civ. Action No. 1:14-cv-03875 (N.D. Ill. May 22, 2014); SEC Litigation Release No. 23007 (May 28, 2014) (announcing fraud charges against Illinois Stock Transfer Company and its owner, alleging misappropriation of money belonging to their corporate clients and the clients' securityholders in order to fund their own payroll and business); In the Matter of Securities Transfer Corporation and Kevin Halter, Jr., Exchange Act Release No. 64030 (Mar. 3, 2011) (settled action) (finding that transfer agent and its president failed to ensure that transfer agent had adequate supervisory procedures and a system for applying such procedures to safeguard client funds held in its custody or possession from internal employee abuse perpetrated by the transfer agent's former bookkeeper).

and securities held in a transfer agent's custody in either physical or electronic form could present significant custody or delivery risks to issuers, securityholders, and the financial system as a whole. In addition, funds and securities in custody of transfer agents could also be subject to risk of loss from recordkeeping errors (e.g., where the transfer agent is unable to reconcile the origin and ownership of funds or securities held), attachment (e.g., in the event of a judgment against the transfer agent), and insolvency (e.g., securityholder or issuer funds could be commingled with transfer agent funds and therefore, in the event of bankruptcy, treated as general assets of the transfer agent and not as separately identifiable investor or issuer funds).[387]

Further, even routine paying agent activity, such as dividend distribution processing, may be complex. For example, after determining record date eligibility, the paying agent (who may be a transfer agent) will calculate and balance the cash dividend amount or, in the case of a stock dividend, the equivalent number of shares, which the transfer agent will issue, register, and deliver, either in certificated or book-entry form. The paying agent may then handle the printing, posting, and distribution[388] of dividend payments to the issuer's registered securityholders,[389]

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387 As noted in Section I, a transfer agent's failure to perform its recordkeeping duties can create significant risks. These risks may be heightened where a transfer agent maintains the only electronic record of ownership of an issuer's securities, such as when facilitating an issuer's DRS program whereby the transfer agent, not DTC, maintains electronic book-entry custody and records of shares.

388 Disbursements may be by check, electronic deposit into a securityholder bank account, or reinvestment in additional shares of the company through a DRIP or a Direct Stock Purchase Plan ("DSPP"). Additionally, some larger transfer agents may provide currency exchange services to international investors, allowing them to select the currency in which they want their dividend payments or sale proceeds to be calculated and paid.

389 Where securities are held in street name registered to DTC's nominee, Cede & Co., rather than issuing thousands of individual checks or securities directly to registered securityholders, the paying agent will deliver funds (or newly issued securities generated by certain corporate actions) to DTC. DTC then electronically credits the accounts of the appropriate banks and brokers, which in turn credit the payments and/or securities to the accounts of the beneficial owners. For additional information about DTC's

either directly or through a third-party service provider. The paying agent may also reconcile all checks and disbursements from the dividend account, and thereafter may also offer ancillary payment services to securityholders, such as: (i) corresponding with securityholders regarding uncashed or stale-dated distribution payments or distribution payments declared lost or stolen; (ii) placing stops on checks or certificates that are certified to be lost or stolen; (iii) reissuing replacement checks and securities where necessary; (iv) providing photocopies of paid checks; and (v) preparing and mailing dividend tax reporting forms required by the Internal Revenue Service.

Other distributions, like those arising from lawsuits or settlements, may require special attention. For example, to ensure that only investors who held shares between specific dates or meet other detailed tests are compensated for a specific settlement, transfer agents who are engaged to perform distribution activities must carefully review ownership records to determine who is entitled to receive a payment and in what amount. Any processing errors at any point in this complex process could present substantial risks for both issuers and securityholders. For example, if there is a substantial positive adjustment to the share price following the payment date, a transfer agent's failure to calculate or distribute the correct amounts to securityholders could create risk of loss of funds or securities for investors, as well as risk of liability for the issuer, transfer agent, and others involved in the processing. A transfer agent's inadvertent failure to reinvest a dividend payment or an erroneous distribution of a cash payment could create similar risks.

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Corporate Actions Processing Service for distributions, see Corporate Actions Processing, DTCC, http://www.dtcc.com/asset-services/corporate-actions-processing.aspx.

Despite the amounts involved and risks posed, only one of the existing transfer agent rules – recently amended Rule 17Ad-17 – specifically refers to and directly addresses certain limited conduct of paying agents.[390] Other Commission rules indirectly address activity implicated by the paying agent role, but do not specifically address the complex administrative, recordkeeping, and processing activities associated with transfer agents' activities as paying agents, nor do they provide definitive standards to determine the adequacy of the transfer agent's safeguards or prescribe specific requirements for how transfer agents in such instances should protect funds and securities from misappropriation, theft, or other risk of loss. In particular, Rule 17Ad-12 requires transfer agents to assure that funds and securities in their possession or control are "protected, in light of all facts and circumstances, against misuse," and that all such securities "are held in safekeeping and are handled, in light of all facts and circumstances, in a manner reasonably free from risk of theft, loss or destruction."[391] Rule 17Ad-13 requires transfer agents to file an annual report prepared by an independent accountant concerning the transfer agents' systems of internal accounting control and related procedures for the safeguarding of related funds.

More specificity and a more robust set of standards against which paying agent activities can be measured may be necessary to better protect investors, facilitate the prompt and accurate clearance and settlement of securities transactions, and keep pace with the evolving roles transfer agents occupy in this space. We intend to propose new rules or rule amendments to address transfer agents' expanded role in handling investor funds and securities, as well as the increase in

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390 See supra Section IV.A.4 for additional discussion of Rule 17Ad-17.

391 Exchange Act Rule 17Ad-12, 17 CFR 240.17Ad-12.

the number and types of transactions currently facilitated by transfer agents. In particular, the Commission intends to propose new rules or amend Rule 17Ad-12 to require transfer agents to comply with specific minimum best practices requirements related to safeguarding funds and securities, such as: (i) maintaining secure vaults; (ii) installing theft and fire alarms; (iii) developing specific written procedures for access and control over securityholder accounts and information; (iv) enhanced recordkeeping requirements; and (v) specific unclaimed property procedures. The Commission also intends to propose a rule requiring transfer agents to segregate client funds to ensure that bank accounts are appropriately designated to protect client funds from being counted as transfer agent funds in the event of insolvency, and to obtain written notification from banks holding the funds that the funds are for the exclusive benefit of the customers, not the transfer agent.

In addition, the Commission intends to propose new rules for transfer agents similar to those recently adopted for registered broker-dealers regarding amended annual reporting, independent audit, and notification requirements, which are designed to, among other things, increase broker-dealers' focus on compliance and internal controls.[392] In light of the activities and risks associated with their paying agent activities discussed above, the Commission preliminarily believes it would be appropriate to implement similar rules for transfer agents, including rules requiring transfer agents to prepare and file annual financial reports consisting of a statement of financial condition, a statement of income, a statement of cash flows, and certain other financial statements, similar to those discussed above in Section VI.A in connection with

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392 For a discussion of the recent amendments to the requirements for broker-dealers, see Broker-Dealer Reports, Exchange Act Release No. 70073 (July 30, 2013), 78 FR 51910 (Aug. 21, 2013).

new registration and annual reporting requirements. The Commission intends to propose new rules to require transfer agents acting as paying agents or custodians to prepare and maintain current and detailed policies and procedures reasonably designed to comply with any new or amended possession and control requirements for the safeguarding of customer funds and securities. In connection with these proposals, the Commission also intends to propose certain amendments to Form TA-2 requiring transfer agents to disclose the number and/or dollar value of residual and unclaimed funds. Finally, the Commission intends to propose amendments to Rule 17Ad-12 to provide specific requirements for the safeguarding of uncertificated securities, including appropriate controls and limitations on access to a transfer agent's electronic records.

The Commission seeks comment on the following:

18. Would the anticipated proposals described immediately above appropriately strengthen practices and procedures involving the safeguarding of funds and securities by transfer agents? Are there other areas that the Commission should consider? If so, what regulatory or other action to address any areas of weakness or risk should the Commission consider? Please provide a full explanation.

19. Should the Commission require transfer agents to file on a periodic basis information disclosing whether and how a transfer agent maintains custody of issuer and securityholder funds and securities, similar to the information broker-dealers are required to report quarterly? Why or why not? What benefits, costs, and burdens would result? Please provide a full explanation.

20. In addition or as an alternative to the anticipated proposals described above, should the Commission provide specific guidelines or requirements for transfer agents' paying agent and custody services? Why or why not? What should those guidelines or requirements be? Do commenters believe the lack of such guidelines or requirements results in varying practices and standards among transfer agents, or specific areas of weakness or risk? Why or why not? Please provide a full explanation.

21. What are the current best practices with respect to the safeguarding of funds and securities (e.g., segregation of accounts, written procedures, specific internal controls, limits on employee access to physical items and records, and to computer systems, as well as other access controls)? Do commenters believe that Rules 17Ad-12, 17Ad-13, and 17Ad-17 are effective in encouraging those best practices? Are there differences in how funds are safeguarded between smaller

and larger transfer agent firms? Please provide a full explanation.

22. What are the current best practices with respect to the creation, maintenance, and reconciliation (or other use) of financial or other records that might bear upon the safety of customer funds and securities? Should the Commission require any such best practices, such as: (i) monitoring the financial position of the transfer agent by preparing, maintaining, and reconciling financial books and records, including a statement of financial condition, a statement of income, a statement of cash flows, and certain other financial statements; and (ii) adopting internal written procedures or specific internal controls requiring the monthly reconciliation of all bank accounts used in a transfer agent's business, and requiring audits of the effectiveness of these internal controls by independent public accountants? Why or why not? Please provide a full explanation.

23. Should the Commission require transfer agents to file certain additional reports prepared by an independent public accountant on the transfer agent's compliance and internal controls? Why or why not? In connection with any such requirement, should the Commission require transfer agents to allow representatives of the Commission or other ARA to review the documentation associated with certain reports of the transfer agent's independent public accountant and to allow the accountant to discuss with representatives of the Commission or ARA the accountant's findings associated with those reports when requested in connection with an examination of the transfer agent? Why or why not? Please provide a full explanation.

24. Do commenters believe that there are different risks associated with transfer agents maintaining issuer or securityholder funds at banks that are part of the same holding company structure as the transfer agent, as opposed to a wholly unaffiliated bank? Why or why not? If there are distinct risks, should the Commission act to mitigate those risks, and if so, how? Should the Commission prohibit a transfer agent from maintaining issuer and securityholder funds at a bank that is affiliated with the transfer agent? If so, how should "affiliated bank" be defined? Should transfer agents that are also custodian banks be required to maintain a segregated special account or accounts at an unaffiliated bank or other approved location? Why or why not? Please provide a full explanation.

25. If transfer agents were to be required to deposit or transmit issuer and securityholder funds into a special bank account, should the Commission also limit the amount of funds that could be deposited in special accounts at a bank to reasonably safe amounts, whether the bank is affiliated or non-affiliated? Why or why not? If so, what amounts should the Commission consider reasonably safe? Should such amounts be measured against the capitalization of the transfer agent and/or the bank? Why or why not? Please provide a full explanation.

26. What are the current insurance requirements and/or practices among transfer agents, and what is the source of those requirements and/or practices? Would

different or additional insurance requirements address current paying agent risks, such as loss or misuse of funds? Why or why not? If so, what types and amounts of insurance would be sufficient to address current paying agent risks? Why? If the Commission proposes specific insurance requirements for transfer agents, should it also require transfer agents to establish and maintain written policies and procedures describing their process for evaluating and procuring insurance (such as fidelity, professional indemnity, cybersecurity, errors and omissions and surety coverage) and for determining the coverage amounts? Should the transfer agent's annual accountant's report on internal controls required by Rule 17Ad-13 include verification that the transfer agent has fulfilled these requirements? Please provide a full explanation.

27. What are the industry best practices with respect to safeguarding procedures specific to residual or unclaimed funds and securities remaining in the transfer agent's possession or control post-payment but prior to the successful distribution to securityholders or escheatment to a state or territory?

28. If the Commission were to require transfer agents to disclose information pertaining to residual or unclaimed funds, what type of information and level of detail should be required, and how frequently should it be required to be reported? What would be the cost, burdens or benefits, if any, of such disclosure for issuers or transfer agents?

29. Currently, Rule 17Ad-5 only requires a transfer agent who has not handled disbursements or dividends for at least three years to respond to inquiries by simply indicating the agent is no longer the paying agent. What volume of such requests do paying agents typically receive annually? Do paying agents typically know who the current agent is? What would be the costs, burdens or benefits if paying agents were required to provide such information? Please provide a full explanation.

30. What would be the costs, benefits, and burdens, if any, of the proposals described above?

D. <u>Restricted Securities and Compliance With Federal Securities Laws</u>

Transfer agents play a particularly important role in the securities industry with respect to the issuance and transfer of restricted securities. Restricted securities cannot be resold legally unless there is an effective registration statement for their resale, or there is an available exemption from registration for the resale. Typically, these securities bear restrictive legends indicating that their sale or transfer may be subject to a restriction or limitation and intermediaries will not effectuate their transfer until restrictive legends are removed. Because transfer agents are often the party responsible for affixing, tracking, and removing restrictive legends, they play an important role in helping to prevent unregistered securities distributions that violate Section 5 of the Securities Act of 1933 ("Securities Act").[393] The need to prevent unregistered securities distributions is particularly acute in the microcap market, where OTC issuers may not be subject to certain of the Commission's disclosure requirements and there is an increased potential for fraud and abuse because potential investors have few, if any, resources for obtaining meaningful disclosure or conducting independent research on microcap issuers.

The Commission's experience in investigating abuses in the microcap market and bringing enforcement actions charging violations of the federal securities laws demonstrates how the removal of restrictive legends can often be a central element contributing to illegal, unregistered distributions of securities. While these actions typically involve misconduct by persons other than the transfer agent, the Commission has charged transfer agents as culpable participants in a variety of circumstances. Transfer agents may face potential liability for aiding and abetting or causing a violation of Section 5 of the Securities Act for an act or omission that contributes to or helps effectuate an illegal unregistered distribution.[394] In some cases, we have brought an action against the transfer agent for violating Section 5 on the theory that the transfer

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393 See Securities Act Section 5, 15 U.S.C. 77e.

394 See, e.g., National Stock Transfer, Inc., A.P. File No. 3-9949, Sec. Act Rel. No. 7924 (Dec. 4, 2000) (settled proceeding against transfer agent and an officer of the transfer agent for willfully aiding and abetting and causing Section 5 violations by issuing shares in reliance on an issuer's representation of an S-8 transaction that had been purportedly registered with the Commission when no such registration existed); Holladay Stock Transfer, Inc., A.P. No. 3-9567, Sec. Act Rel. No. 7519 (Mar. 25, 1998) (settled cease and desist proceeding against transfer agent and president for, among other charges, willfully aiding and abetting and causing Section 5 violations by an issuer client).

agent was a "necessary participant" and "substantial factor" in the unregistered distribution or sale.[395] Depending on the facts and circumstances, a transfer agent also could incur liability pursuant to the anti-fraud provisions of the federal securities laws,[396] such as Section 10(b) of the Exchange Act,[397] Rule 10b-5 thereunder,[398] and Section 17(a) of the Securities Act.[399]

Some transfer agents have expressed concern, however, that they perceive a conflict in some instances between their obligation to take appropriate steps to forestall an illegal distribution, and their obligation under state law to comply with a valid request to issue a security or facilitate a transfer, which may require removal of a restrictive legend.[400] Nonetheless, if a transfer would be unlawful under the federal securities laws, the transfer agent is not required by state law to comply with a request for transfer.[401] We note that the person or

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[395] See, e.g., Registrar and Transfer Company, A.P., Exchange Act Rel. No. 73189, para. 21 (Sep. 23, 2014) (settled action against transfer agent and its chief executive officer for, respectively, willfully violating Sections 5(a) and 5(c) and causing the transfer agents' violations); SEC v. CMKM Diamonds, Inc., 2011 WL 3047476 (granting summary judgment for violations of Section 5 against transfer agent and its principal as necessary participants and substantial factors in unlawful distribution), rev'd, 729 F.3d 1248, 1259 (9th Cir. 2013) (holding that "undisputed facts do not establish that [transfer agent and its principal] were substantial participants . . . as a matter of law"); SEC v. CIBC Mellon Trust Co., Civ. Action No. 1:05-cv-0333 (PLF) (D.D.C. Feb. 16, 2005) (settled action charging a transfer agent with primary violations of Section 5 in addition to primary and aiding and abetting liability in a 10b-5 fraud to promote, distribute, and sell the stock of issuer Pay Pop, Inc. where Pay Pop officers paid a senior manager at the transfer agent bribes in the form of Pay Pop shares to obtain transfer agent services).

[396] See, e.g., id.

[397] Exchange Act Section 10, 15 U.S.C. 78j.

[398] Exchange Act Rule 10b-5, 17 CFR 240.10b-5.

[399] Securities Act Section 17(a), 15 U.S.C. 77q(a).

[400] See, e.g., Robert Feyder, Transfer Agents Beware: A Request to Remove a Restrictive Legend May be the Equivalent of a Request to Register Transfer, The Securities Transfer Association, Inc. Newsletter, Issue 2 (2002).

[401] See Campbell v. Liberty Transfer Co., 2006 U.S. Dist. LEXIS 91568 (E.D.N.Y. Dec. 19, 2006) (holding that transfer agent could not be found liable for requiring that certificate be legended and refusing to honor transfer absent attorney opinion letter; federal law precluded the transfer agent from treating the shares as if they were freely tradable; to conclude that plaintiff's request for transfer required action by the transfer agent would be inconsistent with the Supremacy Clause); Catizone v. Memry Corp., 897 F. Supp. 732

entity requesting a transfer of restricted securities based on an exemption from the registration requirements of the Securities Act bears the burden of proving entitlement to that exemption.[402] Further, it appears that issuers (and their transfer agents) may reasonably withhold consent to register a transfer until they can determine that the request "is in fact rightful" under Section 8-401(a)(7) of the UCC.[403] Because the relevant determinations can involve the assessment of legal issues that are fact-dependent,[404] transfer agents typically may seek to rely on representations or opinions provided by the issuer or securityholder and their counsels, usually in the form of an "attorney opinion letter," to determine whether an exemption from registration under Section 5 of the Securities Act is applicable. As our enforcement experience demonstrates, however, this process is also susceptible to abuse, as many illegal distributions are facilitated by the improper issuance of such opinion letters.[405]

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(S.D.N.Y. 1995) (holding that since the transfer violated the Securities Act, it cannot be considered rightful under Section 8-401 of the U.C.C. and transfer agent was under no duty to register the transfer); Charter Oak Bank & Trust Co. v. Registrar & Transfer Co., 358 A.2d 505 (N.J. Sup. Ct. 1976) (holding that a transfer agent cannot be required by state law to transfer stock in violation of the Securities Act, therefore, when a transfer agent has reasonable cause to believe that a transfer will be in violation of the Securities Act, it has the right to refuse to make the transfer until it has received an explanation or showing that the proposed transfer would not violate the Securities Act).

402 See, e.g., SEC v. Ralston Purina Co., 346 U.S. 119 (1953); Gilligan, Will & Co. v. SEC, 257 F.2d 461 (2d Cir. 1959); SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959); Edwards v. United States, 312 U.S. 473 (1941).

403 If any of the preconditions enumerated in UCC Section 8-401 do not exist, such as where a transfer is wrongful, the issuer is under no duty to register the transfer. See U.C.C. 8-401, cmt. 1.

404 These issues can include determining a securityholder's affiliate status with the issuer or identifying the holding period during which an individual held restricted securities. See Securities Act Rule 144(b)(2), 17 CFR 230.144(b)(2) (providing for different conditions for use of the rule on affiliates than on non-affiliates); Securities Act Rule 144(d)(1), 17 CFR 230.144(d)(1) (providing for a holding period for restricted securities).

405 See, e.g., SEC v. Gendarme Capital Corp., 2012 WL 346457 (E.D. Cal. Jan. 31, 2012) (denying defendant's motion to dismiss Section 5 claims, where Commission's complaint alleged that attorney issued more than 50 opinion letters to transfer agents containing false statements); SEC v. Czarnik, 2010 WL 4860678 (S.D.N.Y. Nov. 29, 2010) (denying defendant's motion to dismiss Section 5 charges where

More specificity around transfer agents' responsibilities with respect to illegal distributions may help to better protect investors, facilitate the prompt and accurate clearance and settlement of securities transactions, and combat fraud and manipulation in the microcap market. We therefore intend to propose new rules or rule amendments to address transfer agents' role in facilitating transfers of securities that result in illegal distributions of securities. In particular, the Commission intends to propose a new rule prohibiting any registered transfer agent or any of its officers, directors, or employees from directly or indirectly taking any action to facilitate a transfer of securities if such person knows or has reason to know that an illegal distribution of securities would occur in connection with such transfer.

We also intend to propose a new rule prohibiting any registered transfer agent or any of its officers, directors, or employees from making any materially false statements or omissions or engaging in any other fraudulent activity in connection with the transfer agent's performance of its duties and obligations under the Exchange Act and the rules promulgated thereunder, including any new or amended rules the Commission may promulgate in the future, such as those dealing with transfer agents' safeguarding, paying agent, and other activities discussed above in Section VI.C and throughout this release. We also intend to propose a new rule requiring each registered transfer agent to adopt policies and procedures reasonably designed to achieve compliance with applicable securities laws and applicable rules and regulations thereunder, and to designate and specifically identify to the Commission on Form TA-1 one or more principals to serve as chief compliance officer.

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complaint alleged, among other things, that attorney drafted false opinion letters provided to transfer agents).

The Commission seeks comment on the following:

31. Is there a need for Commission rules clarifying transfer agent liability for participating in or facilitating an unlawful distribution of securities in violation of Section 5 of the Securities Act? Why or why not? If so, what rules should be considered?

32. Currently, there are no specific Commission rules regarding the placement or removal of restrictive legends by transfer agents. Is there a need for Commission rules governing the role of transfer agents in placing or removing restrictive legends? Why or why not? If so, what are the specific issues that should be addressed by Commission rulemaking?

33. Should the Commission provide specific guidelines and requirements for registered transfer agents in connection with removing a restrictive legend and in connection with issuing any security without a restrictive legend, such as: (1) obtaining an attorney opinion letter; (2) obtaining approval of the issuer; (3) requiring evidence of an applicable registration statement or evidence of an exemption; and/or (4) conducting some level of minimum due diligence (with respect to the issuer of the securities, the shareholder and/or the attorney providing a legal opinion)? Why or why not? Should the Commission also consider specific recordkeeping and retention requirements related to the issuance of share certificates without restrictive legends? Why or why not? How should book-entry securities be addressed? Are there other guidelines or requirements the Commission should consider with respect to the issuance of share certificates or book-entry securities without restrictive legends?

34. If the Commission were to issue any standards for restrictive legend removal, what would be an appropriate level of due diligence? Should any due diligence requirements be compatible with current state law governing the issuance and transfer of securities? Should the Commission consider specific guidelines and requirements for the review of representations that a shareholder is not an affiliate of the issuer or is not acting in coordination with other shareholders? Why or why not? If so, what guidelines or requirements should be considered? Should the Commission consider specific guidelines and requirements regarding transfer agents' obligations to review or determine the ultimate beneficial ownership of shares, identification of control persons of the shareholders, and relationship of shareholders to the issuer, officers or each other?

35. Do transfer agents currently possess detailed and accurate information regarding the ownership history of the securities they process? For example, do transfer agents know whether the securities they process were ever owned by a control person or other affiliate of the issuer, and for how long? If so, how do they know this? If transfer agents possess such information, do they provide it to other market intermediaries, such as broker-dealers and securities depositories? If not, should transfer agents be required to do so? Has the inability of broker-dealers

and other market intermediaries to obtain detailed and accurate securities ownership information facilitated the unlawful distribution of securities? Has it impaired secondary market liquidity, such as by making other market intermediaries unwilling or less willing to handle certain securities? If so, how can the Commission address these issues?

36. Should transfer agents be permitted to rely on the written legal opinion of an attorney under certain circumstances? If so, what should those circumstances be? For example, should there be requirements regarding the attorney's qualifications or the attorney's relation to the issuer or investor? Is it appropriate for transfer agents to rely on attorney opinion letters to the extent the letters are based on representations of the issuer or third parties without the attorney's review of relevant documentation or independent verification of the representations?

37. Should the Commission obligate transfer agents to: (i) confirm the existence and legitimacy of an issuer's business (for example by reviewing leases for corporate offices, etc.); (ii) obtain names and signature specimens for persons the issuer authorizes to give issuance or cancellation instructions, together with any documents establishing such authorization; (iii) conduct credit and criminal background checks for issuers' officers and directors and shareholders requesting legend removal; (iv) obtain and confirm identifying information for shareholders requesting legend removal (e.g., legal name, address, citizenship); and/or (v) obtain and review publicly-available news articles or information on issuers or principals? Why or why not?

38. Should the Commission enumerate a non-exhaustive list of "red flags" or other specific factors which would trigger a duty of inquiry by the transfer agent? Why or why not? If so, which "red flags" should be included?

39. Are there types of securities or categories of transactions commenters believe should require a heightened level of scrutiny or review by transfer agents before removing a restrictive legend or processing a transfer? If so, which ones and why? What should any such heightened scrutiny or review entail? For example, should the Commission require additional diligence requirements for securities offered by issuers that are not required to file financials with the Commission? Why or why not?

40. The Commission is aware that industry participants have suggested that the Commission provide a safe harbor for transfer agents from direct liability or secondary liability (e.g. aiding and abetting) in connection with an unregistered distribution of securities if the transfer agent follows the procedures set out in the

safe harbor concerning legend removal.[406] Should the Commission impose such a safe harbor? Why or why not? If so, what should be the specific conditions of the safe harbor?

41. Other than ensuring that the removal of restrictive legends is appropriate and not a means to sidestepping registration requirements, what requirements or prohibitions, if any, should the Commission consider as additional protections against the unlawful distribution of unregistered securities? For example, should transfer agents be required to deliver securities certificates directly to registered securityholders or be prohibited from delivering securities certificates to third parties that are not registered as owners of the certificates on the transfer agents' books? Why or why not?

42. In what form (e.g. certificate form or book-entry form) are restricted securities held and issued today? Please provide specific data and examples and, where available, breakdowns by asset class. To what extent, if any, do holders of restricted securities own those securities in street name today? To the extent restricted securities are held in book-entry form, what practices are used in the marketplace today with respect to sending securityholders account statements generally and, specifically, sending account statements bearing restrictive legends? Are any special issues created by intermediation, such as by broker-dealers, of any restricted securities held in street name? Should the Commission consider rules governing the display of legends on account statements of shareholders who hold restricted securities in book-entry form? Are there are any technological or regulatory barriers to the application of restrictive legends to securities held in DRS form? Should the Commission regulate transfer agent processing of securities that are held in DRS form?

43. The Commission's staff understands that transfer agents may receive compensation in-kind in the form of securities of the issuer that hired the agent to remove restrictive legends. Does this create additional or different risks than if the transfer agent were paid in cash? If so, should the Commission limit transfer agents' acceptance of securities as payment for services related to penny-stock securities or small issuers, or acquiring shares of the issuers they are servicing through other means, such as gift or purchase? Why or why not?

44. What costs, benefits, and burdens, if any, would the potential requirements discussed above create for issuers or transfer agents?

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406 See Rhodes, supra note 18, at § 6:12 ("Attempts are now being made to persuade the SEC to adopt a procedure and a form which, when presented to a transfer agent, would free the transfer agent from liability in making the transfer in reliance on the form.").

45. Should the Commission require transfer agents to maintain, implement, and enforce written compliance and/or supervisory policies and procedures, similar to those required of broker-dealers? Why or why not? If so, what policies and procedures should be required? Should the Commission require transfer agents to disseminate written policies and procedures to all employees of the transfer agent on an annual or semi-annual basis? Why or why not? Please explain.

46. Should the Commission adopt rules requiring registered transfer agents to designate and identify a chief compliance officer? Why or why not? If so, should the Commission adopt rules governing the reporting lines and relationships of the chief compliance officer? Should the chief compliance officer be required to file an annual compliance report with the Commission? Why or why not? If so, what information should be included in the annual compliance report?

47. Should the Commission require transfer agents to undertake security checks or confirm regulatory and employment history for employees, certain third-party service providers, and associated persons, and to require certain employees of registered transfer agents to register with the Commission? Why or why not? What would be the costs, benefits, and burdens associated with such a requirement? What challenges does the trend toward the outsourcing and offshoring of certain aspects of transfer agents' functions pose for ensuring compliance with such a requirement? Please provide a full explanation.

48. Should the Commission require transfer agents to obtain certain information concerning their issuer clients, clients' securityholders and their accounts, and securities transactions? Why or why not? Please explain and provide supporting evidence where applicable. Should transfer agents be required to perform a form of due diligence on their clients and the transactions they are asked to facilitate, similar to the know-your-customer requirements applicable to broker-dealers? Should transfer agents be required to obtain a list of all affiliates of their issuer clients—including current and former control persons, promoters, and employees—and to take special precautionary steps whenever they are asked to process transactions for these affiliates?

49. Should the Commission require transfer agents to maintain originals of all communications received and copies of all communications sent (including both paper and electronic communications) to or from the transfer agent related to its business? Why or why not? Please explain.

E. Cybersecurity, Information Technology, and Related Issues

Cybersecurity risk is a specific type of operational risk and includes risks related to the security of data stored on computers, networks, and similar systems, and technology-related disruptions of operational capacity. Given the increased use of and reliance on computers, networks, and similar systems throughout society, cybersecurity threats are omnipresent today. They come from many sources and present a significant risk to a wide range of American interests, including critical governmental and commercial infrastructures, the national securities markets, and financial institutions and other entities that are involved in the National C&S System. In 2012, a single group targeted and attacked more than a dozen financial institutions with a sustained Distributed Denial of Service attack on those institutions' public websites.[407] That same year, 89% of global securities exchanges identified cyber-crime as a potential systemic risk and 53% reported experiencing a cyber-attack in the previous year.[408]

Cybersecurity risks faced by the capital markets and Commission-regulated entities are of particular concern to the Commission. Given the highly-dependent, interconnected nature of the U.S. capital markets and financial infrastructure, including the National C&S System, as well as the prevalence of electronic book-entry securities holdings in that system, the Commission has a significant interest in addressing the substantial risks of market disruptions and investor harm posed by cybersecurity issues.

Transfer agents are subject to many of the same risks of data system breach or failure that other market participants face. With advances in technology and the enormous expansion of book-entry ownership of securities, transfer agents today rely more heavily than ever on technology and automation for their core recordkeeping, processing, and transfer services,

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407 FSOC Annual Report 2013, sec. 7.2, p. 136. The attacks began in September and "were targeted, persistent, and recurring."

408 See Rohini Tendulkar, Cyber-crime, securities markets and systemic risk, Joint Staff Working Paper of the IOSCO Research Department and World Federation of Exchanges (July 16, 2013), available at http://www.iosco.org/research/pdf/swp/Cyber-Crime-Securities-Markets-and-Systemic-Risk.pdf. Forty-six securities exchanges responded to the survey.

especially the use of computers and networks to store, access, and manipulate data, records, and other information. As a result, modern transfer agents are vulnerable to a variety of software, hardware, and information security risks which could threaten the ownership interest of securityholders or disrupt trading not only among registered securityholders but, because of transfer agents' electronic linkages to DTC, also among street name owners. For example, a software or hardware glitch, technological failure, or processing error by a transfer agent could result in the corruption or loss of securityholder information, erroneous securities transfers, or the release of confidential securityholder information to unauthorized individuals. A concerted cyber-attack or other breach could have the same consequences, or result in the theft of securities and other crimes.[409]

Cybersecurity issues have been analyzed and discussed in detail over the last several years in a variety of fora.[410] For example, the Commission has adopted a number of rules in recent years to address cybersecurity and related issues, although most of them either do not apply to registered transfer agents or do not address transfer agents' specific activities. In 2015, the Commission adopted Regulation SDR ("Reg SDR"), which addresses registration requirements, duties, and core principles for security-based swap data repositories ("SDRs") and

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409 See generally, SEC Cybersecurity Roundtable transcript (Mar. 26, 2014), available at https://www.sec.gov/spotlight/cybersecurity-roundtable/cybersecurity-roundtable-transcript.txt.

410 See, e.g., id.; see also OCIE Risk Alert, "OCIE's 2015 Cybersecurity Exam Initiative," Vol IV, Issue 8 (Sept. 15, 2015); OCIE Risk Alert, "Cybersecurity Examination Sweep Summary," Vol IV, Issue 4 (Feb. 3, 2015); Luis A. Aguilar, Comm'r, SEC, Speech at "Cyber Risks and the Boardroom" Conference of the New York Stock Exchange (June 10, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370542057946 (Boards of Directors, Corporate Governance and Cyber-Risks: Sharpening the Focus); Luis A. Aguilar, Comm'r, SEC, Speech at SINET Innovation Summit (June 25, 2015), available at http://www.sec.gov/news/speech/threefold-cord-challenge-of-cyber-crime.html) (A Threefold Cord — Working Together to Meet the Pervasive Challenge of Cyber-Crime); Michael S. Piwowar, Comm'r, Interview at The World Today (Sept. 17, 2014), available at http://www.abc.net.au/worldtoday/content/2014/s4150439.htm (last visited Dec. 11, 2015).

includes a requirement that every SDR adopt written policies and procedures reasonably designed to ensure that its core systems provide "adequate levels of capacity, integrity, resiliency, availability, and security."[411] However, unless it qualifies as an SDR, a registered transfer agent would not otherwise be subject to these requirements.

In 2014, the Commission adopted Regulation Systems, Compliance and Integrity ("Reg SCI"), which requires entities covered by the rule to test their automated systems for vulnerabilities, test their business continuity and disaster recovery plans, notify the Commission of cyber intrusions, and recover their clearing and trading operations within specified time frames.[412] While Reg SCI covers registered clearing agencies and other entities, it does not apply to transfer agents.[413]

To address cybersecurity risk issues faced by financial institutions (as defined in the Fair Credit Reporting Act) that are registered with the Commission, in 2013 the Commission adopted Regulation S-ID, which requires these entities to adopt and implement identity theft programs.[414]

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411 Exchange Act Rule 13n-6, 17 CFR 240.13n-6. Security-Based Swap Data Repository Registration, Duties, and Core Principles, Exchange Act Release No. 74246 (Feb. 11, 2011), 80 FR 14437 (Mar. 19, 2015).

412 See Regulation Systems Compliance and Integrity, Exchange Act Release No. 73639 (Nov. 19, 2014), 79 FR 72252 (Dec. 5, 2014).

413 Id. at 439-40 (discussing commenters views on whether or not transfer agents and other types of entities should be subject to Reg SCI and noting "should the Commission decide to propose to apply the requirements of Regulation SCI to these entities, the Commission would issue a separate release discussing such a proposal and would take these comments into account."). See also comment letters in response to Regulation Systems Compliance and Integrity (Proposing Release), Exchange Act Release No. 69077 (Mar. 8, 2013): The Securities Transfer Association, Inc. at 2 (Apr. 3, 2013) (commenting that transfer agents should not be subject to Reg SCI because they were not part of the Automation Review Policy (ARP Program) of the Commission existing prior to the proposal of Reg SCI and only large transfer agents have direct connectivity to entities proposed to be covered by Reg SCI); The Investment Company Institute at 3 (July 12, 2013) (transfer agents should not be subject to SCI); Fidelity Investments at 4 (July 8, 2013) (transfer agents should not be subject to SCI because they do not engage in real-time trading and they were not included in ARP Program).

414 See 17 CFR 248.201.

Unless it meets the definition of a financial institution as defined in the Fair Credit Reporting Act, a registered transfer agent would not otherwise be required to comply with Regulation S-ID.[415]

Finally, Regulation S-P was adopted in 2000 and requires certain Commission-registered entities to adopt measures to protect sensitive consumer financial information.[416] Although Regulation S-P primarily covers registered brokers, dealers, investment companies, and investment advisers, it also covers transfer agents in a limited way.[417] In addition, Commission staff has published guidance and other documents addressing cybersecurity risks faced by specific types of Commission registrants, such as corporate issuers, broker-dealers, investment advisers, and investment companies.[418]

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415 See 17 CFR 248.201(a)(1); 15 U.S.C. 1681 (defining "financial institution" to include certain banks, credit unions, and "any other person that, directly or indirectly, holds a transaction account (as defined in Section 19(b) of the Federal Reserve Act) belonging to a consumer."); see also Identity Theft Red Flags Rules, Exchange Act Release No. 69359, 69 n.182 (Apr. 10, 2013), 78 FR 23637 (Apr. 19, 2013) ("SEC staff expects that other SEC-regulated entities described in the scope section of Regulation S-ID, such as…transfer agents…may be less likely to be financial institutions or creditors as defined in the rules, and therefore we do not include these entities in our [cost/benefit] estimates.").

416 See Final Rule: Privacy of Consumer Financial Information (Regulation S-P), Exchange Act Release No. 42974 (June 22, 2000), 65 FR 40334 (June 29, 2000); Disposal of Consumer Report Information, Exchange Act Release No. 50781 (Dec. 2, 2004), 69 FR 71322 (Dec. 8, 2004) (amending rule to require policies and procedures be written).

417 See 17 CFR 248.30(b)(1)(v) ("Every… transfer agent registered with the Commission, that maintains or otherwise possesses consumer report information for a business purpose must properly dispose of the information by taking reasonable measures to protect against unauthorized access to or use of the information in connection with its disposal."); see also Final Rule: Privacy of Consumer Financial Information (Regulation S-P), Exchange Act Release No. 42974 (June 22, 2000), 65 FR 40334 (June 29, 2000).

418 See, e.g., Disclosure Guidance: Topic No. 2, Cybersecurity of the Division of Corporation Finance of the Commission (Oct. 13, 2011), available at https://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm; OCIE Cybersecurity Initiative, National Exam Program Risk Alert Volume IV, Issue 2 (Apr. 15, 2014), available at http://www.sec.gov/ocie/announcement/Cybersecurity-Risk-Alert--Appendix---4.15.14.pdf; Cybersecurity Examination Sweep Summary, National Exam Program Risk Alert Volume IV, Issue 4 (Feb. 3, 2015), available at https://www.sec.gov/about/offices/ocie/cybersecurity-examination-

Further, as discussed above, the Commission's efforts to address transfer agents' safeguarding obligations, including the adoption and application of Rule 17Ad-12,[419] have focused primarily on funds and securities rather than information systems or cybersecurity. Rule 17Ad-12 requires transfer agents to exercise reasonable discretion in adopting safeguards appropriate for their own operations and risks, and a transfer agent can adopt the safeguards and procedures that are most suitable and cost-effective in light of its potential exposure to risk since the reasonableness of safeguards and procedures are tested "in light of all facts and circumstances."[420] The existing rule, however, prescribes no specific requirements for safeguarding additional items of potential value in a transfer agent's possession which potentially could be used to gain access to funds or securities, such as securityholder and account information and data in either physical or electronic form. Based on its experience administering the Commission's transfer agent examination program, the Commission staff is aware that some transfer agents have identified risks related to information and data directly or tangentially related to funds and securities used in their operations, such as securityholder and account information stored on systems and in records, and as a result, have developed policies, procedures, controls, or best practices to mitigate risk. However, the Commission is concerned that widely varying safeguarding procedures and controls among transfer agents could create uncertainty and risk in the market. The Commission is further concerned that insufficient safeguarding of information and data, such as securityholder personal and account information

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sweep-summary.pdf; Cybersecurity Guidance, Division of Investment Management Guidance Update No. 2015-02 (Apr. 2015), available at http://www.sec.gov/investment/im-guidance-2015-02.pdf.

419 Exchange Act Rule 17Ad-12, 17 CFR § 240.17Ad-12.

420 See id.

stored in computer systems and in records, could lead to the loss of information, theft of securities or funds, fraudulent securities transfers, or the misappropriation or release of private securityholder information to unauthorized individuals.

In light of the foregoing, the Commission intends to propose certain amendments to the transfer agent rules to address how technology in general and cybersecurity risks in particular affect transfer agents and their activities, and how transfer agents' technology and information systems, including securityholders' data and personal information, may be related to their safeguarding activities. In particular, the Commission intends to propose new or amended rules requiring registered transfer agents to, among other things: (i) create and maintain a written business continuity plan, tailored to the size and activities of the transfer agent, identifying procedures relating to an emergency or significant business disruption, including provisions such as data back-up and recovery protocols; (ii) create and maintain basic procedures and guidelines governing the transfer agent's use of information technology, including methods of safeguarding securityholders' data and personally identifiable information; and (iii) create and maintain appropriate procedures and guidelines related to a transfer agent's operational capacity, such as IT governance and management, capacity planning, computer operations, development and acquisition of software and hardware, and information security.

The Commission seeks comment on the following:

Safeguarding of Securityholder Information and Data

50. How do commentators understand transfer agents' safeguarding obligations as applied to uncertificated securities? Please be specific.

51. How have transfer agents' data gathering and retention practices evolved in recent years? Do transfer agents collect more or different types of information than in the past? What new risks, if any, have arisen as a result of these changes? Are there some types of information collected by transfer agents that are more valuable to cyber-attackers than others, or that could cause more harm to investors

or the markets if disclosed? If so, please specify. Do transfer agents currently have special protocols to protect their most sensitive information? If not, should the Commission require them to do so?

52. Have transfer agents experienced internal or external access breaches, internal or external fraud or abuse, or other issues associated with creating, accessing, controlling, altering, or securely storing issuer or investor information or data, including securityholders' private account information and other private personal information, whether electronic or otherwise? If so, please describe the nature, extent, and resolution of such problems.

53. What are the most significant risks or threats with respect to such information and data and what challenges do transfer agents face when attempting to assure that it is created, accessed, altered, controlled, and securely stored and retained in a manner reasonably free from identified risks? What policies, procedures, or controls may be employed to mitigate these risks or threats and address these challenges? What is the evidence on the beneficial impact of these practices and does it vary across transfer agents? How and why?

54. Have transfer agents identified risks related to information and data directly or tangentially related to funds and securities used in their operations, such as securityholder and account information stored on systems and in records, electronic or otherwise? Please describe the nature and scope of any such identified risks, as well as any challenges transfer agents face when attempting to mitigate them.

55. Do commenters believe that insufficient safeguarding of information and data, such as securityholder personal and account information stored in computer systems and in records, could lead to the loss of information, theft of securities or funds, fraudulent securities transfers, or the misappropriation or release of private securityholder information to unauthorized individuals? Why or why not? Are commenters aware of any such occurrences or incidents resulting from insufficient safeguarding of information? If so, please describe the nature, extent, and resolution thereof, including any steps perceived as necessary to be taken to prevent a reoccurrence.

56. What are the current industry best practices for protecting issuer or investor information or data in physical or printable records? What minimum standards, if any, should the Commission require for the safeguarding of such information or data?

57. To ensure that data, records, and other types of information stored on computers, networks, and similar systems used by various participants in the National C&S System are safeguarded in a manner that protects investors and promotes the prompt and accurate clearance and settlement of transactions in securities, should Commission requirements apply to certain types of data, records, or other

information, rather than to a particular type of entity? For example, should the Commission impose specific safeguarding, recordkeeping, or other requirements on registered transfer agents and other entities registered or required to be registered with the Commission that possess or control securityholder and account information (electronic or otherwise)? Why or why not? What would be the costs, benefits, and burdens associated with such an approach? Please provide empirical data if available.

Operational Risk, Cybersecurity, and Other Technology-Related Issues

58. Should the Commission impose specific cybersecurity standards for transfer agents? If so, what should they be, and what standard would be appropriate? Should these standards vary depending on the size of the transfer agent or the nature and scope of the services it provides? Do commenters believe Reg SCI or Reg SDR provide an appropriate model for potential transfer agent rules addressing cybersecurity issues? Why or why not? If so, which aspects of Reg SCI or Reg SDR might be most appropriate given the activities of transfer agents? Are there other models that might be appropriate for the Commission to consider when developing cybersecurity rules for transfer agents? Regardless of the framework utilized, should the Commission consider requiring certain minimum cybersecurity protocols, such as practicing good cyber hygiene, patching critical software vulnerabilities, and using multi-factor authentication? Should the Commission require transfer agents to implement heightened security protocols for their most sensitive data? If so, which data would merit special protection, and what form should that protection take? Please provide a full explanation.

59. Should the Commission require transfer agents to demonstrate a certain level of operational capacity, such as IT governance and management, capacity planning, computer operations, development and acquisition of software and hardware, and information security? Why or why not? If so, what requirements should the Commission consider? For example, would it be appropriate to require transfer agents to adopt written procedures concerning all business services performed by, and IT and other systems used by, the transfer agent? Should the requirements be different depending on whether the transfer agent uses proprietary systems or contracts with outside parties for some or all of their services or IT and other systems? Should the requirements be different depending on the size of the transfer agent or the scope of its activities? Please provide a full explanation.

60. If the Commission proposes a rule requiring transfer agents to maintain a written business continuity or disaster recovery plan, what, if any, items should be required to be included in the plans in order to accomplish business continuity and disaster recovery objectives? Please provide a full explanation.

61. What risks do transfer agents face from internal or external cyber attacks? What costs, challenges, or issues do transfer agents face in dealing with those risks (e.g., costs and resources, government and industry cooperation, and information

sharing)? Are there different cybersecurity risks, or different best practices and procedures for addressing such risks, for transfer agents, depending on the size, activities, business lines, or technology infrastructure of the transfer agent? How often do transfer agents review operations and compliance policies and procedures related to cybersecurity?

62. What tradeoffs should the Commission consider in addressing cybersecurity issues with respect to transfer agents? What evidence should it consider in evaluating those tradeoffs, including any benefits, burdens, or costs of specific rule proposals? Please provide a full explanation.

63. Are transfer agents who have offices or do business in multiple jurisdictions subject to different standards or requirements with respect to cybersecurity, data privacy or business continuity? Do those standards or requirements conflict with one another? If so, how and to what extent do those standards conflict?

64. What are the industry best practices with respect to identifying and addressing cybersecurity risk? What are the costs associated with any such best practices? Do commenters believe these costs are reasonable in light of relevant risks?

65. What are industry best practices with respect to protecting electronic communications between and among transfer agents and other market participants using standardized communication protocols and standards? Should the Commission require standards for message encryption? Why or why not? Please provide a full explanation.

66. What consequences for shareholders and issuers could result if the privacy of transfer agent records is compromised? Are there standards to which transfer agents should be required to adhere to reduce the possibility or likelihood of such an occurrence? Similarly, what consequences for shareholders and issuers could result from actions taken by impersonators due to inadequate authentication and/or attempts to cancel or repudiate previously executed instructions? Do the current processes and requirements for signature guarantees apply adequately in an electronic environment?

67. How often do transfer agents review operations and compliance policies and procedures related to cybersecurity? Are third-party vendors utilized and, if so, to what extent? Where third-party vendors are utilized, how do transfer agents conduct oversight of such vendors?

68. Should the Commission require transfer agents to have a minimum level of cybersecurity protection, and if so, what should those levels be? Should the Commission prohibit indemnification of transfer agents by issuers for liability for losses due to the agents' cybersecurity weaknesses? Why or why not?

69. Should the Commission require transfer agents to maintain minimum insurance coverage for operational risks associated with transfer agent operations and services, including cybersecurity losses? Why or why not? Should the level and type of coverage be based on the transfer agent's particular circumstances? If so, what requirements and level of coverage would be appropriate for what circumstances?

70. A new technology, the blockchain or distributed ledger system, is being tested in a variety of settings, to determine whether it has utility in the securities industry.[421] What utility, if any, would a distributed public ledger system have for transfer agents, and how would it be used? What regulatory actions, if any, would facilitate that utility? How would transfer agents ensure their use of or interaction with such a system would comply and be consistent with federal securities laws and regulations, including the transfer agent rules? Please explain.

71. What costs, benefits, and burdens, if any, would the potential requirements discussed above create for issuers or transfer agents?

F. Definitions, Application, and Scope of Current Rules

The Commission intends to propose certain amendments to Rules 17Ad-1 through 17Ad-20 designed to modernize, streamline, and simplify the overall regulatory regime for transfer agents and bring greater clarity, consistency, and regulatory certainty to the area, as well as mitigate any unnecessary costs or other burdens resulting from now obsolete or outdated requirements. In particular, the Commission intends to propose to: (i) rescind Rules 17Ad-18 and 17Ad-21T; (ii) consolidate all definitions, including those in Rule 17Ad-1 and 17Ad-9, as well as specific definitions embedded in Rules 17Ad-5 (written inquiries), 17Ad-15 (signature guarantees), 17Ad-17 (lost securityholders), and 17Ad-19 (cancellation of securities certificates)

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421 See generally, Nasdaq Announces Inaugural Clients for Initial Blockchain-Enabled Platform "Nasdaq Linq", Nasdaq (Oct. 27, 2015), http://www.nasdaq.com/press-release/nasdaq-announces-inaugural-clients-for-initial-blockchainenabled-platform-nasdaq-linq-20151027-00986 (announcement regarding Nasdaq's use of blockchain technology to create a platform for trading shares of privately-held trading); Matthew Leising, Blockchain Potential for Markets Grabs Exchange CEOs' Attention, Bloomberg Business (Nov. 4, 2015), http://www.bloomberg.com/news/articles/2015-11-04/futures-market-ceos-says-blockchain-shows-serious-potential (discussing financial services industry's interest in blockchain technology).

into a single rule; (iii) update various definitions and references throughout the rules to correspond more accurately to the prevailing industry practices and standards, including clarifying that Rule 17Ad-2's turnaround provisions apply with equal force to book-entry securities and clarifying, where appropriate, that other references to "certificates" include book-entry securities, defining the terms "promptly, "as soon as possible," and "non-routine" in Rule 17Ad-2, and other clarifications; (iv) update the current turnaround, recordkeeping, and retention requirements to correspond more closely to the operations and capabilities of modern transfer agents; (v) amend the recordkeeping and retention requirements in Rules 17Ad-7 (record retention), 17Ad-10 (prompt posting of certificate detail, etc.), 17Ad-11 (aged record differences), and 17Ad-16 (notice of assumption and termination) and consolidate them into a single rule; (vi) update the dollar and share thresholds reflected in Rule 17Ad-11 (aged record differences); (vii) amend Rule 17Ad-13 to provide additional and more useful information regarding transfer agents' internal controls; (viii) amend Rule 17Ad-15 to require transfer agents to document in writing their procedures and requirements for accepting signature guarantees; and (ix) propose other new rules and amendments designed to address certain TA activities not currently addressed by the rules, as discussed throughout this release.

Further, the Commission's core books and records rules for transfer agents, Exchange Act Rules 17Ad-6 and 17Ad-7, prescribe minimum recordkeeping requirements with respect to the records that transfer agents must make and record retention requirements specifying how long those records and other documents relating to a transfer agent's business must be kept.[422] These requirements, adopted in 1977, were intended to serve a dual purpose: (1) to assure that transfer agents are maintaining the minimum records necessary to monitor and keep adequate control over their own activities and performance; and (2) to permit the appropriate regulatory authorities to examine transfer agents for compliance with applicable rules.[423] The Commission is concerned that the scope of the recordkeeping and record retention rules may no longer be broad enough to serve this dual purpose relative to the expanded scope of the activities and services that transfer agents provide today as discussed throughout this release. Accordingly, the Commission intends to propose certain amendments to Rules 17Ad-6 and 17Ad-7 to ensure they adequately address: (i) any new or amended registration, reporting, and disclosure requirements adopted by the Commission; (ii) any new or amended contract rules adopted by the Commission; (iii) any new or amended safeguarding requirements adopted by the Commission, including amendments to Rule 17Ad-12; (iv) any new or amended business recovery, information security, operational, or cybersecurity requirements proposed by the Commission; and (v) any conforming or other changes or additions to the Commission's transfer agent rules. The Commission seeks comment on the following:

72. Are any of the current transfer agent rules outdated or obsolete? If so, which ones and why? Do commenters believe that any such outdated or obsolete portions of the transfer agent rules create confusion or inefficiency among transfer agents, issuers, investors, and other market participants? Why or why not? Please provide a full explanation.

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422 Exchange Act Rule 17Ad-6, 17 CFR 240.17Ad-6; Exchange Act Rule 17Ad-7, 17 CFR 240.17Ad-7. For a more detailed description of the recordkeeping and record retention requirements for transfer agents, see supra Section IV.A.2.

423 See Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145.

73. Should the Commission eliminate or amend any of the definitions in the transfer agent rules? If so, which ones and why? For example, should the Commission eliminate references to "control book," "processing," "process" deadlines, and "outside registrar"? Are there any other definitions which should be amended? Why and how? Please provide a full explanation.

74. Should the Commission eliminate the current exemption in Rule 17Ad-4 for small transfer agents? Why or why not? Have circumstances in the industry changed such that the original rationale for this exemption should be reconsidered? Should the Commission take into account the size of a transfer agent, or any other measure, in determining whether the current exemption is appropriate? Why or why not? Please provide a full explanation.

75. Currently, Rule 17Ad-5 (written inquiries and requests) permits transfer agents to respond to certain instructions and inquiries "promptly" rather than within a specified time period unless the requestor provides specific detailed information, such as a certificate number, number of shares, and name in which the certificate was received. In commenters' experience, is the detailed information specified in Rule 17Ad-5 an accurate description of the minimum information necessary to permit a transfer agent to identify the subject of an inquiry or instruction and respond? If not, what other information would allow a transfer agent to identify the subject of the inquiry and respond?

76. Does Rule 17Ad-5 address the full scope of inquiries received by transfer agents? If not, what additional types of inquiries and requests do transfer agents receive, and in what volume? How are those inquiries received (e.g., letter, email, phone, fax, internet)? Should the Commission include additional inquiries within the scope of Rule 17Ad-5? Why or why not? If so, what types of inquiries should be included and what types should be excluded? Please provide a full explanation.

77. Should the Commission update Rule 17Ad-6 to expand the categories and types of records required to be maintained by registered transfer agents? Why or why not? If so, what requirements should the Commission consider? Please provide a full explanation.

78. Should the Commission eliminate or amend the requirement to escrow "source code" in Rule 17Ad-7 (record retention)? Why or why not? How do transfer agents comply with this requirement, and what are the benefits, costs, burdens, and tradeoffs associated with those efforts? If the Commission amends rather than eliminate the requirement, what amendments should the Commission consider? Please provide a full explanation.

79. Rule 17Ad-7(g) requires certain records to be made available to the Commission. What records do commenters believe should be covered by the rule? Are there electronic communication standards in use by the industry to transfer such records and, if so, should the Commission require their use? Why or why not?

80. Are the different record retention requirements in Rules 17Ad-7 (record retentions), 17Ad-10 (prompt posting of certificate detail, etc.), 17Ad-11 (aged record differences), and 17Ad-16 (notice of assumption and termination) still appropriate in light of transfer agents' operational and technological capabilities? Why or why not? Particularly in light of the prevalence of electronic records, should retention periods for all documents be similar? Why or why not? For the records that transfer agents are required to maintain, should the Commission require a longer or shorter retention period? Why or why not? Please provide a full explanation.

81. Does the current definition of certificate detail in Rule 17Ad-9 (definitions) reflect current processes? Why or why not? For example, should the Commission amend the definition to include additional information relevant to identifying the specific security, such as CUSIP number or a unique product identifier if available, or additional information relevant to identifying the investor, such as investor email address and phone number? Why or why not? Do commenters believe such information would help transfer agents identify lost securityholders or improve securityholder communications? Please provide a full explanation.

82. With respect to Rule 17Ad-11 (aged record differences), which requires reports for actual overissuances, should the Commission require transfer agents to provide issuers with information about all aged differences, rather than just differences that lead to overissuance? Why or why not? Are the current dollar and share thresholds reflected in Rule 17Ad-11 appropriate indicators of current or impending problems? Should the thresholds be amended? If so, what thresholds would be more appropriate? Are commenters aware of instances where impending problems were not reported because the dollar or share threshold did not apply to the situation? Please provide a full explanation.

83. Should the Commission again consider expanding Rule 17Ad-14 (tender agents) to include reorganization events such as conversions, maturities, redemptions, and warrants, as it proposed in 1998?[424] Why or why not? Please provide a full explanation.

84. What are the current best practices with regard to accepting signature guarantees, if any? Should the Commission amend Rule 17Ad-15 to require transfer agents to document in writing their procedures and requirements for accepting signature guarantees? Why or why not? Should the Commission require transfer agents to establish and comply with certain minimum procedures and requirements related

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424 Processing of Reorganization Events, Tender Offers, and Exchange Offers, Exchange Act Release No. 40386 (Aug. 31, 1998), 63 FR 47209 (Sept. 4, 1998).

to accepting signature guarantees? Why or why not? If so, what procedures and requirements should be required, and why? Please provide a full explanation.

85. Should the Commission amend Rule 17Ad-16 (notice of assumption)? Why or why not? If so, what amendments should be considered, and why? Is the information required by Rule 17Ad-16 already provided to the industry, including DTC? If yes, how is that information being provided to the industry? Is there an industry standard for electronic communications of these changes? Please provide a full explanation.

86. Are there other amendments to the rules that commenters believe would be appropriate or beneficial that the Commission should consider? Please provide a full explanation.

87. What costs, benefits, and burdens, if any, would the potential requirements discussed above create for issuers or transfer agents?

G. Conforming Amendments

In connection with the potential new rules and rule amendments discussed above, the Commission also intends to propose rules for conforming and other revisions to Forms TA-1 and TA-2 and to Rules 17Ad-1 through 17Ad-20, as appropriate. For example, the Commission may propose to amend Section 8(a)(iv) of Form TA-1 to require disclosure of employees' actual percentage ownership of the transfer agent, rather than whether their percentage ownership falls within a broad range. The Commission also intends to propose defining or clarifying certain terms and definitions used in the forms, such as "independent, non-issuer" and "control," which are not currently defined in Form TA-1, and to clarify the type of disciplinary history required to be disclosed by Question 10. The Commission preliminarily believes that such clarifications would help ensure that transfer agents are interpreting, completing, and filing the requisite forms in a consistent manner. The Commission requests comment on all aspects of the conforming and other amendments described above.

## VII. CONCEPT RELEASE AND ADDITIONAL REQUEST FOR COMMENT

This section discusses additional regulatory, policy, and other issues associated with transfer agents beyond those discussed above in Section VI and seeks comment to identify, where appropriate, possible regulatory actions to address those issues. In particular, we discuss: (i) the processing of book-entry securities by transfer agents; (ii) differences between transfer agent recordkeeping for registered securityholders and broker-dealer recordkeeping for beneficial owners; (iii) characteristics of and issues associated with transfer agents to mutual funds; (iv) crowdfunding; (v) services provided by transfer agents and other entities that act as "third party administrators" for issuer-sponsored investment plans; and (vi) issues associated with outside entities engaged by transfer agents to perform certain services. Throughout, we seek comment regarding the issues raised, and conclude with a series of requests for comment on potential broad changes to the overall regulatory regime for transfer agents that may be appropriate in light of the issues discussed throughout this release.

### A. Processing of Book-Entry Securities

Most municipal and corporate bonds, U.S. government and mortgage-backed securities, commercial paper, and mutual fund securities, are offered almost exclusively in book-entry form (i.e., certificates are not available).[425] While equities have lagged behind this trend, they too have been moving closer to full dematerialization.[426] At the same time, much of the terminology and definitions found in the Commission's transfer agent rules were written, and therefore

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425 See generally, Strengthening the U.S Financial Markets, A Proposal to Fully Dematerialize Physical Securities, Eliminating the Cost and Risks They Incur, A White Paper to the Industry, DTCC 1, 3-6 (July 2012), available at http://www.dtcc.com/~/media/Files/Downloads/WhitePapers/Dematerialize_Securities_Jul._2012.pdf.

426 Id.

reflect, a time when most securities were certificated. For example, the definitions of "item" and "transfer" in Rules 17Ad-1, 17Ad-2, and 17Ad-4 primarily reference certificated securities.[427] Likewise, Rule 17Ad-10, which addresses a transfer agent's buy-in requirement in the event of physical overissuance of securities, refers only to "certificates."[428]

Although many of the transfer agent rules refer only to certificated securities, it has long been the Commission's position that, absent an explicit exemption, all of the transfer agent rules apply equally to both certificated and uncertificated securities, particularly in cases where the rules impose time limits within which a transfer agent must turn around or process a transfer. For example, when adopting Rules 17Ad-9 through 17Ad-13 in 1983, the Commission clarified in its response to public comments that the definition of certificate detail in Rule 17Ad-9 applies with equal force to both certificated and uncertificated securities and related account details.[429] In that same adopting release, the Commission noted that exemptions respecting uncertificated securities are inappropriate in regulations regarding registered transfer agents' accurate creation and maintenance of issuer securityholder records and safeguarding of funds and securities in their operations.[430]

At the same time, the Commission is aware that differences of interpretation among transfer agents may result in widely varying compliance practices, procedures, and controls among transfer agents. For example, because Rule 17Ad-10(g) refers specifically to

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427 See, e.g., Exchange Act Rules 17Ad-1(a)(1)(i), (d), 17 CFR 240.17Ad-1(a)(1)(i), (d).

428 See Exchange Act Rule 17Ad-10(g)(1), 17 CFR 240.17Ad-10(g)(1).

429 See 17Ad-9 through 13 Proposing Release, supra note 2 (noting that the reference to "certificate detail" does not necessarily require the existence of a "certificated security." Rather, it reflects the items of information regarding the registered owner and of the security, regardless of the form of the security.).

430 Id.

certificates,[431] Commission staff have received questions regarding the rule's applicability to overissuances that did not involve certificated securities, indicating that, in applying that rule, some transfer agents may buy-in securities if an overissuance involved certificated securities, but not if it involved book-entry securities.

The Commission believes it is appropriate to consider possible amendments to address the applicability of the transfer agent rules to uncertificated or book-entry securities, including those held in DRS or issued by investment companies such as mutual funds.[432] Accordingly, the Commission seeks comment on the following:

88. Should the Commission amend the existing rules in light of the significant increase in book-entry securities? If so, what approach should the Commission take? For example, although a significant percentage of transfer instructions are categorized as non-routine items under the current rules (such as investor requests for certificates, to close accounts, and to act in certain types of corporate actions), there are no specific processing requirements for non-routine items. Should the same processing obligations apply to all instructions, thereby dispensing with the current routine and non-routine distinctions in Exchange Act Rule 17Ad-1? Alternatively, or in conjunction with that approach, should the existing rules be amended to explicitly apply transfer agents' processing obligations, not only to "transfers" as defined in Rule 17Ad-1, but also to the entire range of instructions a transfer agent may receive, including those related to uncertificated securities, such as purchase and sale orders, balance certificates, establishment and movement of book-entry positions, corporate actions, and updates of securityholder book-entry account information? Why or why not? Are there other approaches that would be appropriate? If so, please describe.

89. What policies, concerns, factors, and other considerations do commenters believe should inform any approach the Commission might take to ensure the transfer

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431 Exchange Act Rule 17Ad-10(g), 17 CFR 240.17Ad-10(g).

432 Exchange Act Rule 17Ad-4(a) exempts from the application of Exchange Act Rule 17Ad-2, among other rules from which it provides exemption, securities held in a DRIP, redeemable securities of registered investment companies (which include open-end investment management companies (i.e., mutual funds)) and limited partnership interests. Consequently, the provisions of Rule 17Ad-2 which are a fundamental part of Commission regulation of transfer agent processing of securities do not apply to mutual fund shares or securities held in Issuer Plans that are DRIPs.

agent rules apply appropriately to book-entry securities? For example, in determining whether a specific rule or requirement is appropriate, should the focus of the Commission's consideration be on the physical nature of the security (whether certificated or uncertificated), or market-based factors, such as whether there is a potential for backlog to occur based on trading volume in the particular type of asset, or both and why? Are there other appropriate considerations? If so, please describe.

90. Given that transfer and other requests now often involve the highly automated processing of book-entry securities rather than manual processing of certificates, should the Commission modify or eliminate the turnaround and processing requirements of Rules 17Ad-1 and 17Ad-2? Why or why not? For example, is the distinction between items received before noon and items received after noon still relevant given that the vast majority of requests are now received and responded to electronically? Should the Commission shorten the timeframe for fulfilling instructions and/or increase the percentage of transfer instructions that must be fulfilled within those timeframes each month? Why or why not?

91. Should the Commission shorten Rule 17Ad-9's permitted timeframes for posting credits and debits to the master securityholder file? Should the Commission require that certificate details be dispatched daily? Why or why not?

92. Are commenters aware of instances where securityholders or broker-dealers cannot determine whether their securities have been processed by transfer agents, despite the requirements of Rule 17Ad-5? If so, please describe any such instances and indicate what requirements, if any, the Commission should consider to address such instances. For example, should the Commission expand the definition of "item" to include presentation by both individual investors and broker-dealers or other intermediaries acting on behalf of individual investors and require transfer agents to report to the presentor of an item the status of any item for transfer not processed within the required timeframes? Why or why not?

93. It is the Commission staff's understanding that investors have brought legal actions against transfer agents under state law to require the transfer agent to effect a transfer, including when the transfer agent claimed the securityholder's instructions were not in good order and therefore the relevant securities were not transferred, or were delayed for a long period of time.[433] Are commenters aware

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433 See, e.g., Kanton v. United States Plastics, Inc., 248 F. Supp. 353 (D.N.J. 1965) (involving common law claims); Bender v. Memory Metals, Inc., 514 A.2d 1109 (Del. Ch. 1986) (involving claim under UCC that transfer was rightful); Mackinder v. Schawk, Inc., No. 00 Civ. 6098 (DAB), 2005 WL 1832385, at *16 (S.D.N.Y. Aug. 2, 2005) (involving shareholder claim under Delaware law to require the removal of restrictive legend reflecting restrictions imposed by stock purchase agreement).

of these or other problems or issues associated with transfer agents failing to effect a securityholder's transfer instructions within a reasonable period of time? If so, please describe the relevant facts and circumstances. For example, what factors might have led to such a situation and how was it resolved? What types of securityholders were directly involved? What were the adverse consequences, if any?

94. Do commenters believe there are problems associated with transfer agents failing to effect or reject transfer instructions within a reasonable time? Should the Commission amend the rules to define what information or documentation is required and from whom it must be received to constitute good order? Should the Commission amend the rules to define the terms "reject" or "rejection" in connection with transfer instructions? Why or why not? Should transfer agents be required to communicate the specific reasons why an instruction was not a good order? Should transfer agents be required to buy-in securities (or take other corrective action to satisfy transfer instructions that were received in good order but not completed after a specific period of time)? If so, should the requirement apply broadly or be limited to specific conditions? Please explain.

95. Are commenters aware of delays in processing incomplete or improper requests for DRS transactions? If so, what caused these delays, and would they be eliminated or reduced if transfer agents were to provide to securityholders the information the securityholder would need to prepare complete instructions for shares held in DRS? Please explain.

96. Given that most securityholders no longer receive paper certificates evidencing their holdings, should the Commission require transfer agents to provide securityholders with an account statement with specific details for each transaction that occurred with respect to each securityholder's account? If so, how and how often should such statements be provided and what information should be included? Please describe.

B. <u>Bank and Broker-Dealer Recordkeeping For Beneficial Owners</u>

Although transfer agents provide critical recordkeeping and transfer services to registered owners, they generally do not have visibility beyond the master securityholder file and therefore rarely provide recordkeeping and transfer services to beneficial owners who hold in street name. Instead, recordkeeping and transfer services usually are provided to beneficial owners by the intermediary through whom the beneficial owner purchased the securities, usually a broker-dealer or bank.[434] Because many securityholders elect to hold exchange-traded securities in street name, many issuers have significantly more beneficial owners than registered owners. As a result, broker-dealers, banks, and other intermediaries may provide recordkeeping and transfer services to a larger portion of a given issuer's shareholder base – the intermediaries' customers – than the registered transfer agent for that issuer.

The transfer and recordkeeping services provided to beneficial owners by banks and brokers are largely identical to the recordkeeping and transfer services provided with respect to registered owners by registered transfer agents. For example, banks and brokers often maintain accountholder information details, process transfers and other changes to accounts, provide securityholder services such as call center support, and provide account statements showing ownership positions for their beneficial owner customers. Yet although these services may be nearly identical to the services provided to registered owners by transfer agents, banks and brokers are typically not required to register as transfer agents under the Exchange Act solely for providing these services to beneficial owners. This is because the positions serviced are

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434 Commission staff understands that some industry participants may refer to the recordkeeping and transfer services provided to beneficial owners by brokers and banks discussed herein as "sub-accounting" or "sub-transfer agent" services. We note that the term sub-transfer agent in this context is not meant to imply a contractual relationship between the registered transfer agent who provides recordkeeping and transfer services for registered owners and the broker or bank that provides the same services for their own beneficial owner customers. Although brokers and banks who act as sub-transfer agents could contract with registered transfer agents to provide recordkeeping and transfer services for their beneficial owner customers, they rarely do so, choosing instead to provide these services themselves.

"securities entitlements" under the UCC rather than "Qualifying Securities" that trigger transfer agent registration.[435]

As street name registration has become more prevalent and the number of registered holders has decreased, more banks and brokers are providing to more investors critical transfer, processing, and recordkeeping services, but are not required to register with the Commission or other ARA as a transfer agent.[436] This raises potential issues regarding the Commission's regulation of securities processing as it pertains to the processing of equity securities by banks, brokers, and other intermediaries.[437] Specifically, if a bank or broker providing transfer and recordkeeping services to beneficial owners is not required to register as a transfer agent with the Commission or other ARA, it will not be required to comply with the Commission's transfer agent rules, including the specific recordkeeping, processing, transfer, and other investor protection requirements imposed by those rules. While some banks and brokers may be subject to certain regulatory requirements depending on their specific activities, those regulations may not specifically address securities processing or provide the same investor protections as do the Commission's transfer agent rules. For example, registered broker-dealers are subject to extensive books and records requirements pursuant to Exchange Act Rule 17a-3, but that rule does not impose the same ownership and transfer recordkeeping requirements as the transfer

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435 See supra note 115 (UCC definition of "securities entitlement"), Section IV.A (discussing provisions of the Exchange Act regarding Qualifying Securities).

436 Id.

437 There are of course other issues raised by the increasing prevalence of bank and broker recordkeeping for beneficial owners, including complexity in the proxy distribution and voting systems and barriers to communication between securityholders and issuers. These issues are beyond the scope of this release but have been discussed in other Commission releases. See, e.g., Final Street Name Study, supra note 82; Proxy Concept Release, supra note 112. We discuss certain issues concerning bank and broker processing of investment company securities below in Section VII.C.4.

agent rules such as Exchange Act Rule 17Ad-10, which imposes detailed information requirements with respect to every securityholder account position.[438] Further, some third party administrators[439] and other intermediaries who provide recordkeeping, administrative, and other services for retirement and issuer plans may not be regulated directly at all by any federal financial regulator. Any risks or other issues associated with these intermediaries' activities become more acute as street name ownership, and the resulting volume of processing of street name book-entry positions by brokers, banks, and other intermediaries providing transfer and recordkeeping services to beneficial owners, continues to increase.[440]

The Commission seeks comment on the following:

97. Are there regulatory discrepancies among transfer agents and banks and brokers who provide similar services for beneficial owners? If so, what are they and do they present risks or raise competition issues in the market for these services? If so, what are the competition issues or risks associated with any such discrepancies, and what approach, if any, should the Commission consider to address them? Please provide a full explanation.

98. Are there reasons why the Commission should regulate transfer agent processing of registered owner securities held in book-entry positions differently than bank and broker processing of street name positions held in book-entry form? If so, please describe them. Please provide a full explanation.

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438 We note, however, that Rule 17a-3 does contain several requirements related to securityholder accounts, such as a "blotter" that shows "the account for which each such transaction was effected" as well as other details, and an "account record" with detailed identifying information for each customer or owner, such as their name, address, and date of birth, as well as their annual income, net worth, and the account's investment objectives.

439 Third party administrators are discussed in more detail below in Section VII.E.

440 For example, Professor Egon Guttman identified the lack of regulation of broker-dealer street name ownership processing as a key regulatory gap and advocated closing it as one of his key recommendations for regulatory improvement. See Egon Guttman, Federal Regulation of Transfer Agents, 34 Am. U. L. Rev. 281, 327-8 (1985), available at http://www.americanuniversitylawreview.org/pdfs/34/34-2/Guttman.pdf.

99. In light of increased obligations under federal law for certain issuers to ascertain their securityholders' identities and the barriers to doing so created by the street name system, as discussed above in Section III.B, should the Commission require entities that are regulated by the Commission, including brokers, banks, or others who provide transfer and recordkeeping services to beneficial owners, to provide or "pass through" securityholder information to transfer agents? If so, what type of information should be provided and how should it be transmitted? What would be the effect on the actions and choices of affected parties, including transfer agents, banks and brokers, issuers, registered owners, and beneficial owners? Please provide a full explanation.

100. If the Commission were to require certain registrants to pass through securityholder information regarding beneficial owners to transfer agents, should the Commission prohibit transfer agents from using such information for other than certain prescribed purposes? If so, for what purposes should such information be allowed to be used, and why? For example, should the information be used solely for the transfer agent's legal/compliance purposes, or should it be permitted to be used for other purposes, such as securityholder communications? Should transfer agents' ability to share information be limited, particularly where information is shared in return for compensation or where information sharing is not fully disclosed to parties such as the issuer or the securityholder? Why or why not? Should such information be permitted to be shared only with the securityholder's consent? Please provide a full explanation.

## C. Transfer Agents to Mutual Funds

U.S. registered investment companies managed $18.7 trillion in assets at year-end 2014.[441] This figure is primarily comprised of mutual funds (i.e., open-end management investment companies or "open-end funds"), but also includes closed-end management investment companies ("closed-end funds") of $289 billion, unit investment trusts ("UITs")[442] of

441 See Testimony of David W. Grim, Director, Division of Investment Management, before the House subcommittee on Capital Markets and Government Sponsored Enterprises (Oct. 23, 2015) ("Grim Testimony").

442 UITs are funds that offer a fixed, unmanaged portfolio, generally of stocks and bonds, as redeemable "units" to investors for a specific period of time, each of which represents an undivided interest in a unit of specified securities. See Investment Company Act Section 4(2), 15 U.S.C. 80a-4(2).

$101 billion, and exchange-traded funds ("ETFs")[443] of approximately $2 trillion, which have seen considerable growth in recent years.[444] While the discussion on transfer agents to mutual funds is focused on open-end funds, the Commission also seeks comment on transfer agents to other registered investment companies as discussed in Section 5 below.

Open-end funds[445] have become one of the main investment vehicles for retail investors[446] in the United States and play a major role in the U.S. economy and financial markets. When the first transfer agent rules were adopted in 1977, there were approximately 477 mutual funds with $48 billion in assets for shareholders in just under 8.7 million accounts.[447] By the end of 2014, there were approximately 7,900 mutual funds with approximately $16 trillion in assets[448] held on behalf of hundreds of millions of investors.[449]

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443 ETFs may be formed as either open-end funds or UITs.

444 See Grim Testimony, supra note 441.

445 Open-end management investment companies are a type of registered investment company under Section 8 of the Investment Company Act that issue redeemable securities. Other types of investment companies include, but are not limited to, closed-end funds and UITs. See Investment Company Act Sections 4(2), 15 U.S.C. 80a-4(2) (definition of unit investment trust) and 5(a) (definition of open and closed-end 1940 Act companies). ETFs are typically organized as open-end funds or UITs.

446 See Grim Testimony, supra note 441; see also Investment Company Institute, 2015 Investment Company Fact Book, 29 (2015), available at http://www.ici.org/pdf/2015_factbook.pdf ("2015 ICI Factbook"). At year-end 2014, retail investors (i.e., households) held the vast majority (89 percent) of the nearly $16 trillion in mutual fund assets, whereas institutions held about 11 percent.

447 2015 ICI Factbook, supra note 446, at 173 (Data sec. 1, tbl. 1).

448 Id.

449 The number of shareholder accounts last reported by the Investment Company Institute ("ICI") was approximately 265 million in 2013 and includes a mix of individual and omnibus accounts (excluding certain underlying beneficial owner accounts), thus understating the total number of shareholder accounts for funds. See ICI, 2014 Investment Company Fact Book, 168 (2014), available at http://www.ici.org/pdf/2014_factbook.pdf.

By mid-2014, 53.2 million households, approximately 43 percent of all U.S. households, owned mutual funds.[450] Today, the typical investor has $103,000 invested in mutual funds, which, for approximately 68 percent of investors, represents more than half of their household financial assets.[451] For many of these investors, mutual funds are their primary source of investing for retirement, higher education, and other financial goals.[452] Historically, many mutual fund investors purchased their shares "direct" from the fund or through the fund's transfer agent.[453] However, today many investors engage an investment professional (also referred to as an "intermediary" for beneficial owners of fund shares), such as a broker-dealer or investment adviser[454] who provides many services, such as helping them identify their financial goals, analyzing an existing financial portfolio, determining an appropriate asset allocation, and (depending on the type of investment professional) providing investment advice or recommendations.[455] In addition, many intermediaries have arrangements with the mutual fund or the mutual fund's transfer agent to perform the underlying shareholder recordkeeping and servicing for their customers' mutual fund positions.[456] Under such arrangements, the

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450 2015 ICI Factbook, supra note 446, at 114 (fig. 6.2).

451 Id.

452 Id.

453 In this section, when discussing transfer agents providing services to mutual funds, we refer to "Mutual Fund Transfer Agents," and when discussing transfer agents to operating company issuers, or issuers whose business is not primarily investing in securities, we refer to "Operating Company Transfer Agents."

454 Also, the 2015 ICI Factbook notes that among households owning mutual fund shares outside employer-sponsored retirement plans, 80 percent own fund shares through investment professionals. Id. at 104.

455 Id. at 104 ("The investment professional also may provide ongoing services, such as responding to investors' inquiries or periodically reviewing and rebalancing their portfolios.").

456 Examples of these services include communicating with their customers about their fund holdings; maintaining their financial records; processing changes in customer accounts and trade orders; recordkeeping for customers; answering customer inquiries regarding account status and the procedures for

intermediary performs recordkeeping on their own books and other services with respect to the beneficial owner, and in many cases aggregates their customer records into a single or a few "omnibus"[457] accounts registered in the intermediary's name on the Mutual Fund Transfer Agent's recordkeeping system.[458]

We understand that the shift to omnibus account arrangements for mutual fund shareholders[459] has altered the landscape of recordkeeping and other services provided to fund investors. This fundamental shift in the roles and responsibilities of traditional shareholder servicing and recordkeeping, however, has resulted in a lack of transparency of beneficial owners, their trading activities and related records.[460]

The complexity of recordkeeping for mutual fund shares also has increased significantly over the last several decades. The total number of mutual fund share classes offered increased

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the purchase and redemption of fund shares; providing account balances and providing account statements, tax documents, and confirmations of transactions in a customer's account; transmitting proxy statements, annual reports and other communications from a fund; and receiving, tabulating and transmitting proxies executed by customers.

457 Omnibus accounts are held by and registered in the name of a single intermediary, such as a broker, and the holdings in the account represent the aggregated positions of multiple beneficial owner customers of the intermediary. Typically, the issuer will not have information regarding the intermediary's underlying beneficial owners. See ICI, Navigating Intermediary Relationships, 3, 6-7 (2009), available at https://www.ici.org/pdf/ppr_09_nav_relationships.pdf. Regarding omnibus relationships generally, see also The Stock Market, supra note 8, at 542.

458 The growth in retirement plan assets also has resulted in a significant increase in the number of third party administrators that perform retirement plan recordkeeping on behalf of mutual fund investors that are plan participants, whose mutual fund positions are held in omnibus accounts on the fund's transfer agent recordkeeping system. Third Party Administrators are discussed further in Section VII.E.

459 See generally, Deloitte, Mutual Fund Directors Digest, The Omnibus Revolution: Managing risk across an increasingly complex service model (2012), available at http://www2.deloitte.com/content/dam/Deloitte/us/Documents/financial-services/us-fsi-fund-director-digest-1-090412.pdf ("Deloitte Digest on Omnibus Revolution").

460 See generally, PricewaterhouseCoopers LLP, Evolution of the Mutual fund Transfer Agent: Embracing the Challenges and Opportunities, 9 (July 2015), available at https://www.pwc.com/us/en/asset-management/investment-management/publications/assets/pwc-mutual-fund-transfer-agent-evolution.pdf ("PWC Evolution of the Mutual Fund Transfer Agent").

from 1,243 share classes in 1984 to over 24,000 share classes in 2014.[461] Historically, as products and share classes evolved, shareholders and their investment professionals looked for diversification by focusing on a mutual fund complex with a broad lineup of funds taking advantage of breakpoint discounts offered on their suite of mutual fund products.[462] In recent years, however, many intermediaries are managing clients' mutual fund investments using advisory type models, where typically a wide range of mutual fund investments from many different fund companies are utilized.[463]

The Commission understands that the growth in both mutual fund products and share classes offered has added complexity and requires Mutual Fund Transfer Agents to maintain, in addition to the master securityholder file, extensive CUSIP databases that define the characteristics and processing rules for each fund share class to ensure prospectus compliance and accurate processing and recordkeeping of mutual fund transactions.[464] As a result, Mutual Fund Transfer Agents have made significant investments in technology advancements to manage

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461 2015 ICI Factbook, supra note 446, at 173 (Data sec. 1, tbl. 1).

462 See generally, ICI Research Perspective, Vol. 20, No.2, Mutual Fund Load Fees (May 2014), available at https://www.ici.org/pdf/per20-02.pdf ("Thirty years ago, fund shareholders usually compensated financial professionals through a front-end load – a one-time, up-front payment for current and future services. That distribution structure has changed significantly."). The report notes that there has been a marked reduction in load fees paid by mutual fund investors, from nearly 4 percent in 1990 to roughly 1 percent in 2013. It also notes that funds often waive load fees on purchases made through retirement plans, as well as waive or reduce load fees for large initial or cumulative purchases.

463 Id. In these advisory arrangements, the investment professional who sells mutual funds is assessing an asset based-fee (a percentage of the net assets managed for an investor), rather than a percentage of the dollars initially invested (a front-end load), utilizing newer free or low-fee share classes designed for advisory type programs. The report also notes that because of the recent trend toward asset-based fees the market share of traditional front-end and back-end load shares has fallen, while the market share of newer share classes that are no-load has increased substantially.

464 We note that, generally, many of the recordkeeping and processing tasks discussed in this section may be performed by either the Mutual Fund Transfer Agent or the intermediary, depending on whether the investor holds his or her mutual fund shares directly with the mutual fund or through an intermediary. We focus herein primarily on transfer agents.

more frequent and diverse transaction processing and shareholder communications through different channels. The industry also has relied heavily on the automation developed through NSCC for processing and settling mutual fund transactions[465] and exchanging and reconciling customer account information, whether held in direct or omnibus accounts.[466]

The growth of the mutual fund industry since 1977, the attendant growth of the portion of the transfer agent community specifically focused on servicing that industry, the proliferation of fund share classes, the growth in intermediary omnibus account arrangements and the Mutual Fund Transfer Agent community, and the complexity of fund processing and reliance on NSCC's systems (discussed below), are among the factors informing the Commission's examination of its transfer agent rules.

### *1. Key Characteristics of Mutual Fund Transfer Agents*

If any person performs for a mutual fund any services listed in Exchange Act Section 3(a)(25), such as registering transfers and transferring registered investment company securities, the person must register with the Commission as a transfer agent pursuant to Exchange Act Section 17A(c)(1).[467] When mutual funds were first introduced, many transfer agents provided these services because the traditional services they offered to operating company issuers (i.e., issuers whose business is not primarily investing in securities), such as maintaining records of stock ownership, paying dividends, sending securityholder communications, and transferring

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465 See DTCC, 2014 Annual Report (2014), available at http://dtcc.com/annuals/2014/wealth-management-services/index.php. The value of mutual fund (Fund/SERV) transactions reported was $4.9 trillion.

466 See PWC Evolution of the Mutual fund Transfer Agent, supra note 460.

467 Exchange Act Section 17A(c)(1), 15 U.S.C. 78q-1(c)(1).

stock ownership, were easily adapted to the particularities of mutual funds.[468] But as mutual fund processing and operations came to involve greater numbers of investors and intermediaries, greater numbers of products, and a broader array of services, some transfer agents evolved with the industry to specialize in the increasingly unique needs of mutual funds, creating a segment of the transfer agent industry that focuses, often exclusively, on servicing mutual funds.[469]

Today, these specialized Mutual Fund Transfer Agents provide many of the same transfer and account maintenance services that other transfer agents perform for operating companies, including the recordkeeping, transfer, and related activities discussed above in Section V.[470] They also commonly provide recordkeeping and other services related to the mutual funds'

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468 Lee Gremillion, Mutual Fund Industry Handbook: A Comprehensive Guide for Investment Professionals (Sept. 2005) ("Mutual Fund Industry Handbook").

469 Id. Today, there is no overlap among the Mutual Fund Transfer Agents with the largest market share and the Operating Company Transfer Agents with the largest market share. Compare SourceMedia, Mutual Fund Service Guide, 41 (2015), available at http://www.mmexecutive.com/mutual-fund-guide/ranking-stats/?service=transfer-agent (providing tables listing the ten largest Mutual Fund Transfer Agents by number of accounts and the eleven largest Mutual Fund Transfer Agents by number of clients) with Jessica Fritz, Audit Analytics, 2013 Transfer Agent Market Share: AST Still On the Rise (Oct. 14, 2013), available at http://www.auditanalytics.com/blog/2013-transfer-agent-market-share-ast-still-on-the-rise/ (providing charts showing the five largest Operating Company Transfer Agents by market share and the six largest Operating Company Transfer Agents by market share of initial public offerings).

470 For example, Mutual Fund Transfer Agents effect transfers in ownership of fund securities, which usually involves making changes to the master securityholder file but not cancelling or issuing certificates because almost all mutual fund securities are issued and held in book-entry form. They also facilitate communications between issuers and securityholders, including by sending to securityholders mutual fund prospectuses, confirmations, periodic account statements, semi-annual and annual reports, and proxy statements. See, e.g., Robert Pozen & Theresa Hamacher, The Fund Industry: How Your Money is Managed, 348 (2nd ed. 2015) ("Pozen & Hamacher") (discussing transfer agent distribution of such materials). Mutual Fund Transfer Agents also distribute to securityholders tax information, such as estimates of fund distributions, Form 1099-DIV and Form 1099B. Id. at 349. They also process cash distributions by the fund, ensuring that cash from distributions is properly credited to securityholder accounts. Id. at 348. In addition, where securityholders elect to reinvest cash distributions by the fund by purchasing additional shares of the fund, Mutual Fund Transfer Agents help facilitate execution of the purchase and calculate and record the number of additional shares purchased. Id.

recordkeeping obligations under the Investment Company Act.[471] However, instead of processing exchange or OTC-traded equity or debt securities, like other transfer agents, Mutual Fund Transfer Agents process redeemable securities of investment companies registered under Section 8 of the Investment Company Act,[472] which under Rule 17Ad-4, are exempt from: (i) the turnaround and processing requirements of Rule 17Ad-2; (ii) the limitations on expansion under Rule 17Ad-3; and (iii) key recordkeeping requirements related to the transfer agent's processing and performance obligations under Rules 17Ad-6(a)(1)-(7) and (11).[473] Thus, although they provide many services identical to those provided by Operating Company Transfer Agents, Mutual Fund Transfer Agents are exempt from the key turnaround, processing, performance, and recordkeeping requirements.

Although many of the core services Mutual Fund Transfer Agents provide are similar to the core services provided by Operating Company Transfer Agents, there are differences. One is the degree to which the securities typically serviced by Mutual Fund Transfer Agents are dematerialized.[474] The mutual fund industry was an early adopter of the practice of issuing shares in book-entry form. By the time the first Commission transfer agent rules were adopted in 1977, registered ownership of mutual fund shares already had been predominantly dematerialized.[475] In contrast, the trend towards dematerialization of registered ownership

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471 See Investment Company Act Rule 31a-1(b)(1), 17 CFR 270.31a-1(b(1) (requiring current journals detailing sales and redemptions of the investment company's own securities and the trade date).

472 See supra note 183.

473 Exchange Act Rule 17Ad-4(a), 17 CFR 240.17Ad-4(a).

474 For discussion of dematerialization, see supra note 69 and accompanying text.

475 See 1971 Study of the Securities Industry Hearings, supra note 299 (statements of David Hughey, Senior Vice President-Operations, Putnam Management Co., Inc. that the percentage of Mutual Fund holders

positions of operating companies evolved over a much longer period of time through some of the incremental developments discussed in this release, such as DRS and issuer plans (e.g., DRIPs). And, for beneficial owners, equity securities issued by operating companies have largely been immobilized in central securities depositories, as discussed above in Sections II and III. Thus, while both Mutual Fund Transfer Agents and Operating Company Transfer Agents today process large numbers of dematerialized securities, Mutual Fund Transfer Agents process them in larger numbers and have been doing so for a longer period of time.

There are also important differences in how Mutual Fund Transfer Agents are organized and compensated compared to Operating Company Transfer Agents generally. For example, there are, in general, three types of Mutual Fund Transfer Agent arrangements: (i) internal (which may also be referred to as "captive," "affiliated" or "full internalization"),[476] (ii) external (which may also be referred to as "third party" or "full service"), and (iii) hybrid (which may also be referred to as "remote vendor").[477] Mutual funds generally tend not to have employees; therefore, internal transfer agent services are not actually provided by the fund. "Internal"

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owning in certificated form dropped from 72 percent in 1956 to 27.5 percent by 1969). It was estimated in 1978 that less than 10% of registered owners of Mutual Fund shares requested certificates. See, e.g., Martin J. Aronstein, The Decline and Fall of the Stock Certificate in America, 1. J. Int'l L. 273, 278 (1978), available at http://scholarship.law.upenn.edu/jil/vol1/iss3/4.

476 Mutual funds generally do not have employees. As a result, the Commission understands that transfer agent services that are characterized as being provided "internally" are not actually provided by the fund but are provided by personnel from the investment adviser to the mutual fund or by an affiliate of such investment adviser.

477 See generally, ICI, The Role and Responsibilities of a Mutual Fund Transfer Agent: Workbook, 4 (2001) ("Mutual Fund Transfer Agent Workbook"); PWC Evolution of the Mutual fund Transfer Agent, supra note 460. For a discussion of one mutual fund complex's evaluation of using the internal ("full internalization"), hybrid ("remote vendor"), or external ("full service") Mutual Fund Transfer Agent models, see In the Matter of Smith Barney Fund Management LLC and Citigroup Global Markets, Inc., Exchange Act Release No. 51761 at 4-15 (May 31, 2005).

transfer agents are typically affiliated with the mutual fund complex, or the fund's investment adviser.[478] The main advantage of an internal transfer agent arrangement is that it allows a mutual fund or fund complex to closely monitor the delivery and quality of services provided to securityholders, which may be important to attracting and retaining investors who value service quality.[479] Larger mutual funds or mutual fund complexes may be more inclined to use internal transfer agents than their smaller counterparts because these funds' sponsors may be better able to undertake the costs required to develop and maintain the extensive technology systems and internal workforce needed to provide service to a large number of accounts.[480] External (or third-party) transfer agents are independent from (as opposed to being affiliated with) the mutual fund and its fund complex or investment adviser. While there may be variation from firm to firm, the external model may not require the same capital expenditures by fund sponsors as for internal transfer agent services, and therefore may be viewed as a cost effective alternative to the internal model.[481]

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478 "Independent" and "affiliated" are used generally in connection with this discussion and are not intended to refer to any particular definition of those terms in any of the provisions of the federal securities laws or other authorities.

479 See, e.g., Mutual Fund Industry Handbook, supra note 468, at 277 ("In many cases, fund groups that outsource their transfer agent back-office functions perform investor service from their own, internal contact centers. This reflects the widespread belief that the quality of this visible service has competitive implications. The back-office functions, by contrast, must be performed correctly, but they offer little opportunity for the fund to differentiate itself from the competition.").

480 See generally, Mutual Fund Transfer Agent Workbook, supra note 477. We note, however, even among larger mutual funds, it is possible for decisions to vary from firm to firm and for similar size firms to come to different conclusions concerning expected costs and the degree to which the mutual fund should internalize transfer agent services when faced with similar factors.

481 It is the understanding of the Commission that these capital expenditures to build and maintain transfer agent technology and infrastructure systems may be absent or reduced in the case of an external transfer agent because an external transfer agent may have already made these investments in the past and, to the extent some or all of the cost of those investments may be passed on to transfer agent issuer clients, the full

External transfer agents have their own business model, processing and procedural routines, computer systems, and service providers.[482] Because of this independence, the mutual fund or mutual fund complex may have less input or control over how a fund's securityholders are ultimately serviced. For this reason, some mutual funds use a hybrid transfer agent arrangement, whereby an internal transfer agent performs certain services in an effort to maintain control over the quality of the securityholder servicing relationship, and other services are sub-contracted to an external transfer agent.[483] For example, many mutual funds using a hybrid arrangement will use an external transfer agent for core record-keeping functions and an internal transfer agent for securityholder servicing, especially when such servicing involves direct interaction with mutual fund securityholders.[484] As a result, there may be significant variation in services provided, technology resources and capability, and corporate structure and organization among Mutual Fund Transfer Agents.

Mutual Fund Transfer Agents may also have different compensation arrangements than typical Operating Company Transfer Agents, which generally will be compensated on a per securityholder account basis. While Mutual Fund Transfer Agents may also be compensated on

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extent of the redistributed cost is unlikely to be borne by a single issuer and is more likely to be diffused across multiple issuers.

482 In contrast to mutual funds, operating companies with a large number of shareholders rarely use the internal or hybrid models and nearly always use an external transfer agent, although there are exceptions where a public company serves as its own transfer agent, particularly among local utility companies and local banks where the administration to service stockholders as a transfer agent is already in place and where the stockholders are often customers of the company.

483 See, e.g., supra note 479 (discussing internal servicing and quality of service).

484 See, e.g., Mutual Fund Industry Handbook, supra note 468, at 277 (citing ICI, Mutual Funds and Transfer Agent Billing Practices 1997 (1998) (finding that 87 percent of 483 funds surveyed performed such securityholder servicing "internally" (i.e., using personnel from the management company or an affiliate of the management company)).

a per securityholder account basis, many of them instead receive compensation based on a percentage of a fund's net assets.[485] Mutual Fund Transfer Agent fees are typically the second largest expense borne by mutual funds, exceeded only by the investment management fee.[486]

### 2. *Increased Complexity*

As a result of the collective effect of the five factors discussed below, transaction processing for Mutual Fund Transfer Agents may be more complex or involve additional responsibilities as compared to Operating Company Transfer Agents. First, Mutual Fund Transfer Agents receive cash and perform calculations as a part of regular processing of transactions in shares of mutual funds to a greater extent than is involved in the day-to-day work of Operating Company Transfer Agents. As a general matter, unlike publicly traded equity securities, mutual fund securities are redeemable, meaning that investors in mutual fund securities (or their intermediaries) purchase or redeem mutual fund shares directly with the mutual fund itself rather than on the secondary market.[487] Mutual fund securities must be purchased and redeemed at their current net asset value ("NAV") per share next computed after receipt.[488] Investor orders to purchase mutual fund shares are ultimately received by a Mutual

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485 Fee arrangements may vary from Mutual Fund Transfer Agent agreement to agreement and other fee permutations are possible, for example as an at-cost arrangement between an internal Mutual Fund Transfer Agent and the fund.

486 See, e.g., Mutual Fund Industry Handbook, supra note 468, at 231 ("Transfer agent service is typically the largest component of a fund's expense after investment management."); H. Kent Baker, Greg Filbeck & Halil Kiymaz, Mutual Funds and Exchange-Traded Funds: Building Blocks to Wealth, 406 (2015) (analyzing 2014 data of one Mutual Fund and finding $21 million in transfer agent fees to have been the fund's second largest expense after $65 million in investment management fees).

487 See Investment Company Act Sections 5(a), 2(a)(32), 15 U.S.C. 80a-5(a), 80a-2(a)(32) (defining open-end companies and redeemable securities, respectively).

488 See Investment Company Act Rule 22c-1 17 CFR 270.22c-1. Under Rule 22c-1, commonly called the "forward pricing" rule, an investor who submits an order before the next computed NAV, generally

Fund Transfer Agent, regardless of whether the investor's order is submitted directly by the investor or is submitted by an intermediary such as a broker (including where a broker may submit the order via NSCC's Fund/SERV system).[489] After receiving a purchase order, Mutual Fund Transfer Agents calculate the number of shares purchased in some cases (such as where the investor indicates the dollar amount the investor seeks to purchase rather than the number of shares). With respect to purchase orders from investors, Mutual Fund Transfer agents collect the payment for those shares, deposit the payment into the account of the custodian of the mutual fund, issue on behalf of the mutual fund the shares to be purchased, and record the transaction on the master securityholder file of the mutual fund.[490] Mutual Fund Transfer Agents engage in a comparable process when an investor decides to redeem shares in a mutual fund.

Second, Mutual Fund Transfer Agents also play a role that serves to assist in the determination of the appropriate price for an investor's purchase or redemption order (which is based on the NAV per share and any applicable commissions or fees). They do so by coordinating with mutual fund administrators, who commonly perform the main calculations that

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calculated by most funds as of the time when the major U.S. stock exchanges close at 4:00 pm Eastern Time, receives that day's price, and an investor who submits an order after the pricing time receives the next day's price. See generally, Amendments to Rules Governing Pricing of Mutual Fund Shares, Investment Company Act Release No. 26288 (Dec. 17, 2003), 68 FR 70388 (Dec. 17, 2003) (proposing release).

489 For additional details regarding Fund/SERV, see Exchange Act Release No. 22928 (Feb. 20, 1986), 51 FR 6954 (Feb. 27, 1986) (File No. SR-NSCC-85-09); Exchange Act Release No. 25146 (Nov. 20, 1987), 52 FR 45418 (Nov. 27, 1987) (File No. SR-NSCC-87-08); Exchange Act Release No. 26376 (Dec. 20, 1988), 53 FR 52544 (Dec. 28, 1988) (File No. SR-NSCC-88-08); Exchange Act Release No. 31487 (Nov. 27, 1992), 57 FR 56611 (Nov. 30, 1992) (File No. SR-DTC-92-02).

490 See, e.g., Exchange Act Release No. 12440 (May 12, 1976), 41 FR 22595 (June 4, 1976) (ICI comment letter (July 19, 1976)) ("The mutual fund transfer agent receives cash for investment in mutual fund shares and pays cash to shareholders for the redemption of outstanding shares."); Pozen & Hamacher, supra note 470 ("The transfer agent is responsible for collecting payment for share purchases and arranging for its deposit into the fund's bank account.").

assist a mutual fund in determining its NAV.[491] The coordination with the mutual fund's administrator is necessary, not only because Mutual Fund Transfer Agents must process purchases and redemptions at current NAV as described above, but because current NAV as calculated by the administrator on behalf of the mutual fund must reflect changes in the number of shares of the mutual fund outstanding pursuant to Investment Company Act Rule 2a-4(a)(3).[492] Because the Mutual Fund Transfer Agent is the entity primarily responsible for keeping track of this information on behalf of the mutual fund, the administrator typically receives this record of changes in the capital stock of the mutual fund from the Mutual Fund Transfer Agent. Because Mutual Fund Transfer Agent transaction processing is price-dependent as described above, if an error is made and later discovered in connection with some aspect of this process, the Mutual Fund Transfer Agent may need to reprocess all of the purchases and redemptions that were affected by the error ("as of" transaction processing). Both the daily NAV and any corrections are communicated by Mutual Fund Transfer Agents to intermediaries for transaction processing conducted on behalf of beneficial owners of mutual funds.

Third, some mutual funds may provide their investors with options which may add additional complexity to the Mutual Fund Transfer Agent's or intermediary's processing tasks. For example, many mutual funds allow investors to exchange a mutual fund within the same

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491 The Commission understands that most mutual funds and other investment companies that are required to register with the Commission contract with one service provider for transfer agent services and a different provider for fund "administration," which generally involves services such as calculation of NAV and management fee accruals. In contrast, it is the understanding of the Commission that many private funds (i.e., investment funds not registered with the Commission) use a single service provider for both transfer agent and administration functions.

492 See Investment Company Act Rule 2a-4(a)(3), 17 CFR 270.2a-4(a)(3) ("Changes in the number of outstanding shares of the registered company resulting from distributions, redemptions, and repurchases shall be reflected no later than in the first calculation on the first business day following such change.").

fund complex without having to pay a sales load or other fee for purchasing shares of the new mutual fund. This arrangement may require Mutual Fund Transfer Agents (or intermediaries) to determine if the exchange qualifies for a waiver of the sales charge and to track the total time the investor has been invested in the mutual fund complex. In addition, some mutual funds may offer other services and options, such as systematic withdrawal plans, that may require Mutual Fund Transfer Agents and their intermediaries to keep track of a potentially wide range of securityholder elections, transaction types, and prospectus and business processing rules in CUSIP databases that are utilized for transaction processing.

Fourth, the use of different sales load structures and distribution methods, particularly with respect to redemption of mutual fund securities, as well as other fee payments to intermediaries, also adds complexity in the mutual fund context. For example, for load funds, or funds that charge a sales load to the investor, Mutual Fund Transfer Agents commonly process and distribute related commission payments to intermediaries in connection with sales of mutual fund shares.[493] As part of a distribution strategy, some mutual funds compensate distributors such as broker-dealers with trail commissions that are processed and distributed by the Mutual Fund Transfer Agent, even after completion of a sale.[494] A Mutual Fund Transfer Agent may process redemption fee charges or track relevant information and give effect to sales load discounts (often referred to as breakpoints) for direct investors, often based on the amount

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493 In addition, if the mutual fund has a contingent deferred sales load (often referred to as a "back-end load"), transfer agents commonly process and distribute these commissions to distributors in connection with a redemption.

494 See Investment Company Act Rule 12b-1, 17 CFR 270.12b-1.

invested or intended to be invested. Mutual Fund Transfer Agents also may process and distribute ongoing sub-transfer agency fees to intermediaries.[495]

Fifth, Mutual Fund Transfer Agents traditionally have functioned in a more central role in connection with clearing and settlement of securities transactions than have Operating Company Transfer Agents. With a mutual fund purchase or redemption, there is no clearing corporation involved that serves to novate trades as a central counterparty as in the case of a broker-facilitated trade in an equity security on a national securities exchange (as shown in Figure 1 in Section III.B above) because mutual funds generally are not exchange-traded.[496] As a result of this clearance and settlement environment, Mutual Fund Transfer Agents interact with sub-transfer agents such as broker-dealers, who hold shares on behalf of their beneficial owner customer, similar to the way in which DTC interacts with Operating Company Transfer Agents.[497] Mutual Fund Transfer Agents also maintain on the master securityholder file omnibus positions for intermediaries (on behalf of the intermediaries' beneficial owner-customers), which is similar to the way in which DTC maintains securities accounts of participants, but there is no jumbo Cede & Co. position at DTC in the case of a mutual fund.

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495 See supra Section VII.B for a discussion of sub-transfer agents.

496 While as discussed above, there is no clearing corporation that serves as central counterparty in mutual fund transactions, there are services provided by NSCC, such as Fund/SERV and Networking. This centralized clearance and settlement platform employs standardized data fields and protocols for mutual fund transaction processing and daily net settlements, through which intermediaries such as brokers may transmit and settle orders with Mutual Fund Transfer Agents. For additional details regarding Fund/SERV, see supra note 489.

497 See supra note 113 for definition of sub-transfer agent.

### 3. *Compliance and Other Services*

Many Mutual Fund Transfer Agents may assist mutual funds with their compliance obligations, not only with respect to general recordkeeping obligations, but also to enable mutual funds to comply with regulations to which operating companies may not be subject in the same way or at all.[498] One such obligation is that mutual funds have various "client on-boarding" requirements under federal law[499] and commonly rely upon their Mutual Fund Transfer Agent to do the work that will enable the mutual fund to meet such obligations. For example, mutual funds are required to implement anti-money laundering (AML) programs pursuant to an interim final rule of the Treasury.[500] In addition, mutual funds are required to establish customer identification programs pursuant to a joint rule of the Commission and Treasury.[501] That rule requires, at a minimum, that the mutual fund verify an investor's identity to the extent reasonable and practicable, maintain records of the information used to verify identity, and determine whether the investor appears "on any list of known or suspected terrorists or terrorist organizations issued by any federal government agency and designated as such by Treasury in

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498 Regarding general recordkeeping obligations, <u>see</u> Investment Company Act Rule 31a-1(b)(1), 17 CFR 270.31a-1(b)(1) (requiring current journals detailing sales and redemptions of the investment company's own securities and the trade date).

499 <u>See, e.g.</u>, Bank Secrecy Act Section 5312(a)(2) (including "investment compan[ies]" within the definition of "financial institution"). Transfer agents may also be subject directly to related federal requirements that do not apply solely to "financial institutions." <u>See, e.g.</u>, Section 6050I of the Internal Revenue Code,26 U.S.C. 6050I (requirement to report to Internal Revenue Service receipt of cash in excess of $10,000 in a single or related transaction).

500 <u>See</u> Financial Crimes Enforcement Network, Anti-Money Laundering Programs for Mutual Funds, 67 FR 21117 (Apr. 29, 2002).

501 31 CFR 103.131; <u>see</u> Customer Identification Programs for Mutual Funds, Investment Company Act Release No. 26031 (Apr. 29, 2003), 68 FR 25131 (May 9, 2003).

consultation with the federal functional regulators."[502] While mutual funds bear ultimate responsibility for compliance, as a practical matter, the customer identification processes commonly are carried out by Mutual Fund Transfer Agents for direct investors.[503] In addition, mutual funds are required to report suspicious transactions ("Suspicious Activity Reports") to the Treasury's Financial Crimes Enforcement Network.[504] Mutual Fund Transfer Agents may assist the mutual fund in filing the Suspicious Activity Reports.

Mutual Fund Transfer Agents may also assist mutual funds in complying with requirements related to the price-dependent nature of mutual fund transaction processing. First, Mutual Fund Transfer Agents may be responsible for monitoring, on behalf of the mutual fund, that intermediaries such as dealers are properly separating orders received from customers before NAV is next computed from those received afterwards and are sending them in separate batches to the Mutual Fund Transfer Agent.[505] As another example, mutual funds are entitled to receive

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502 Id.

503 See, e.g., Pozen & Hamacher, supra note 470 (discussing transfer agent verification of investor identity information as part of the mutual fund share purchase process); Id. at 352 ("Funds must take steps to avoid providing a laundry service for criminals with dirty money. As mentioned earlier, transfer agents verify a customer's identity when they open an account, under what are referred to as the *know your customer*, or KYC rules.") (emphasis in the original); Practising Law Institute, Mutual Funds and Exchange Traded Funds Regulation § 1A:3.1 Money Laundering (Clifford A. Kirsch ed., 3rd ed. 2014) ("Most funds accomplish AML compliance through their transfer agents and distributors.")

504 31 CFR 103.15(a)(1); see Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations--Requirement That Mutual Funds Report Suspicious Transactions, 68 FR 2716 (Jan. 21, 2003); see also Guidance, Frequently Asked Questions, Suspicious Activity Reporting Requirements for Mutual Funds, FIN-2006-G013 (Oct. 4, 2006) (authorizing mutual fund to use an agent to file reports but stating the "mutual fund remains responsible for assuring compliance with the regulation and must monitor performance by the service provider.").

505 See Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) (reliance solely on "contractual provisions with transfer agents and other intermediaries that obligate those parties to segregate orders received by time of receipt in order to prevent "late trading" based on a previously determined price" would be "insufficient to meet the

taxpayer identification numbers of beneficial owner customers upon request under shareholder information agreements that mutual funds (other than money market mutual funds and mutual funds that expressly authorize short-term trading) must enter into pursuant to Investment Company Act Rule 22c-2(a)(2) with financial intermediaries who submit orders on behalf of beneficial owner customers.[506] Mutual Fund Transfer Agents commonly assist the mutual fund's review of this taxpayer identification number and related transaction information in order to monitor against trading practices that may dilute the value of the outstanding securities issued by the mutual fund.[507]

#### 4. *Broker-Dealer Recordkeeping for Beneficial Owners Who Invest In Mutual Funds*

As happens in the operating company space, many securities intermediaries such as broker-dealers and banks perform recordkeeping and processing services for their customers who are beneficial owner investors in mutual funds.[508] A key difference is that frequently a mutual fund will compensate the intermediary pursuant to an agreement with the intermediary for the provision of those services to fund investors, typically based on the number of shareholder accounts or a percentage of the net assets of the fund, or some combination thereof. However, most operating companies do not compensate intermediaries for servicing their beneficial owner

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requirements of the new rule. Funds should . . . also take affirmative steps to . . . obtain[] assurances that those policies and procedures are effectively administered.").

506 Investment Company Act Rule 22c-2(a)(2), 17 CFR 270.22c-2(a)(2).

507 See id. (authorizing a Mutual Fund Transfer Agent to enter into the shareholder information agreement on behalf of the mutual fund with the financial intermediary).

508 See Section VII.B for a discussion of the transfer and account maintenance-related services performed by broker-dealers and banks for their beneficial owner customers and related issues. We note that the relationship between fees received by intermediaries for these types of "sub-transfer agent" services and the 12b-1 fee plan of a mutual fund is beyond the scope of this release.

customers. The oversight and invoicing for these payments is often delegated to the Mutual Fund Transfer Agent,[509] who will commonly process and distribute ongoing sub-transfer agency fees to intermediaries.

Because intermediaries are compensated for providing recordkeeping and processing services for their customers who are beneficial owner investors in mutual funds, many of the issues discussed above in Section V.D.3 are relevant to Mutual Fund Transfer Agents. "Networking" of a single investor's account or position potentially gives Mutual Fund Transfer Agents more transparency through to beneficial owners than is available to Operating Company Transfer Agents, because the recordkeeping for such accounts is primarily kept on the Mutual Fund Transfer Agent's system. "Networking" is a service provided by NSSC by which Mutual Fund Transfer Agents can also exchange general shareholder account data with intermediaries such as brokers that provide sub-transfer agency services.[510] This service provides for different levels of securityholder account networking between mutual funds and securities

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509 See generally, ICI, Financial Intermediary Controls and Compliance Assessment Engagements (2015), available at https://www.ici.org/pdf/ppr_15_ficca.pdf. The mutual fund industry has developed a standardized framework, the Financial Intermediary Controls and Compliance Assessment Engagement (FICCA), for intermediary oversight, where fund sponsors are seeking assurances on the effectiveness of the intermediary's control environment. The framework calls for the omnibus account recordkeeper to engage an independent accounting firm to assess its internal controls related to specified activities the intermediary performs for fund shareholder accounts. FICCA is performed under attestation standards issued by the AICPA and the auditor report expresses an opinion on its evaluation of an intermediary's assertion that controls were suitably designed and operating effectively. The framework includes 17 areas of focus, including document retention and recordkeeping, transaction processing, shareholder communications, privacy protection and anti-money laundering. It is the understanding of the Commission that FICCA engagements are voluntary and some intermediary reports may not provide an assessment on all 17 areas of focus.

510 Data communicated via NSSC Networking may include: (i) shareholder elections regarding the settlement of cash dividends and capital gains distributions (such as by check or direct deposit), (ii) reinvestment elections, (iii) address changes, (iv) the financial adviser associated with the account, and (v) tax reporting information. See Mutual Fund Transfer Agent Workbook, supra note 477, at 84.

intermediaries.[511] Networked accounts are in the name of the intermediary on the master securityholder file but can represent both individual customers and omnibus accounts. Nevertheless, Networking's advantages are less utilized today as many beneficial owner accounts are now held in omnibus accounts that may also be networked. Thus, due in part to the increasing prominence of the omnibus account, Mutual Fund Transfer Agents' ability to look-through to beneficial owners has decreased.

The use of breakpoints historically highlights some of the issues faced by Mutual Fund Transfer Agents that are associated with recordkeeping and processing services provided by intermediaries.[512] A 2003 joint report of the staffs of the Commission, NASD and NYSE, found that "[t]he dramatic growth in the number of [mutual fund] families, share classes, and, to a lesser extent, customer account types, has increased the complexity of applying breakpoints appropriately."[513] The Staff Report also noted that whereas "in the past, broker-dealers dealt directly with mutual fund transfer agents and disclosed the customer's identity to them, the increasing prominence of omnibus account arrangements and sub-transfer agency services

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511 Intermediary accounts can be networked at three levels (0, 3 and 4), providing different information concerning underlying beneficial owners. In Level 3, the intermediary handles all aspects of the customer relationship and the customer does not interact with the Mutual Fund Transfer Agent. In Level 4, the Mutual Fund Transfer Agent handles all client communications, and customers as well as their intermediary may interact with the Mutual Fund Transfer Agent. Level 0 refers to a bank trust networked account that functions similar to a Level 3 account, and the term also is used when referencing non-networked accounts.

512 Some mutual funds that charge front-end sales loads will charge lower sales loads for larger investments (i.e., "breakpoints). For addition information on breakpoints, see Final Rule: Disclosure of Breakpoint Discounts by Mutual Fund, Exchange Act Release No. 49817 (June 7, 2004), 69 FR 33262 (June 14, 2004).

513 Staff Report: Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds (Mar. 2003), available at https://www.sec.gov/news/studies/breakpointrep.htm.

provided to these accounts by intermediaries such as brokers had made the tasks related to the application of breakpoints more challenging."[514]

Finally, the Commission understands that there has been a movement to omnibus sub-accounting arrangements over the years for mutual fund shareholders[515] and that this movement has resulted in a fundamental shift in the roles and responsibilities of traditional shareholder servicing and recordkeeping.[516] The Commission is examining the issues or concerns that may arise in connection with the lack of visibility that issuers and transfer agents acting on their behalf may have regarding the records maintained by intermediaries for their customers who are beneficial owners of mutual funds that are being serviced through omnibus and sub-accounting arrangements.

### 5. *Discussion and Request for Comment*

Given these developments, as well as the proliferation and growth of registered investment companies, including open-end funds, closed-end funds, UITs[517] and ETFs,[518] the

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514 Id.; see also infra Section C.4 for additional discussion of Mutual Fund sub-transfer agent issues.

515 See generally, Deloitte Digest on Omnibus Revolution, supra note 459; Deloitte, The Omnibus Revolution; managing risk across an increasingly complex service model (2012), available at http://www.deloitte.com/view/en_US/us/Industries/Private-Equity-Hedge-Funds-Mutual-Funds-Financial-Services/e89659d4db516310VgnVCM3000001c56f00aRCRD.htm.

516 See generally, PWC Evolution of the Mutual fund Transfer Agent, supra note 461; PricewaterhouseCoopers, LLP, Evolution of the mutual fund transfer agent: Embracing the challenges and opportunities (July 2015), available at http://www.pwc.com/us/en/asset-management/investment-management/publications/mutual-fund-transfer-agent-evolution.html.

517 See supra note 442.

518 The first Commission transfer agent rules were adopted in 1977. See generally, supra Section IV.A. The advent of ETFs occurred more than a decade later. For examples of some of the earliest ETFs authorized under Commission exemptive orders, see, e.g., SPDR Trust, Series 1, Investment Company Act Release No. 18959 (Sept. 17, 1992) (notice), 19055 (Oct. 26, 1992) (order); Diamonds Trust, Investment Company Act Release No. 22927 (Dec. 5, 1997) (notice), 22979 (Dec. 30, 1997) (order). For a discussion of key characteristics of ETFs, see Request for Comment on Exchange-Traded Products, Exchange Act Release

Commission believes it is appropriate to examine the regulation of transfer agents who provide services to registered investment companies.

In particular, the Commission seeks comment regarding the regulation of transfer agents to registered investment companies based on the unique trading, market, asset class, and other relevant characteristics of the registered investment companies they service. Some of the issues posed by these unique characteristics of these registered investment companies are illustrated by the potentially different treatment of UITs and closed-end funds with respect to the Rule 17Ad-4(a) exemptions, despite the many similarities that have existed historically among the secondary market trading characteristics of UITs and closed-end funds. Closed-end funds typically trade in a secondary market and often list on a national securities exchange for trading. By definition under Section 5 of the Investment Company Act, the securities of closed-end funds are not redeemable (i.e., the investor does not have a right to require the fund to redeem the investor's shares in exchange for a proportionate share of the fund's underlying asset or cash equivalent thereof).[519] As a result, transfer agents servicing closed-end funds do not qualify for the Rule 17Ad-4(a) exemption, with respect to closed-end funds.[520] In contrast, transfer agents servicing UITs qualify for the exemption because UIT units are redeemable.[521] Yet, although UIT units

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No. 75165 (June 12, 2015), 80 FR 34729 (June 17, 2015); Exchange-Traded Funds, Investment Company Act Release No. 28193 (March 11, 2008), 73 FR 14618 (March 18, 2008).

519 While a closed-end fund investor may not have the right to require the fund to redeem the investor's shares, in some cases, a closed-end fund may elect to purchase shares from its investors if they wish to sell their shares. See also Investment Company Act Rules 23c-1 through 23c-3, 17 CFR 270.23c-1 through 23c-3.

520 See 17Ad-1-7 Proposing Release, supra note 165, at n.14 ("The turnaround rules do apply to registered transfer agents performing transfer agent functions for securities issued by closed-end investment companies.")

521 Id.

are redeemable, because UITs are static trusts, redemptions of the UIT would require the UIT to dilute the corpus of the trust in order to meet redemption requests (whether paid out by the UIT in cash or met by distributions by the UIT of in-kind assets of the UIT). Therefore, just like closed-end funds, in order to provide liquidity to selling shareholders, historically UITs commonly have been traded in a secondary market, typically made up of broker-dealers, but UITs typically do not list their shares on a national securities exchange for trading as closed-end funds often do.[522] Thus, UITs and closed-end funds are treated differently for purposes of Rule 17Ad-4, despite historically having similar trading characteristics.[523]

The Commission also seeks comment with respect to the Rule 17Ad-4(a) exemptions. As discussed above, although Mutual Fund Transfer Agents provide many of the same recordkeeping, transfer, account maintenance, and related services that Operating Company Transfer Agents provide, under Rule 17Ad-4(a) they are exempt from some of the turnaround, processing, performance, and recordkeeping requirements that make up the foundation of the

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522 See Thomas Harman, Emerging Alternatives to Mutual Funds: Unit Investment Trusts and Other Fixed Portfolio Investment Vehicles, 1987 Duke L.J. 1045, 1046 (1987), available at http://scholarship.law.duke.edu/dlj/vol36/iss6/4/; Gould and Lins, Unit Investment Trusts: Structure and Regulation under the Federal Securities Laws, 43 Bus. Law. 1177, 1185 (Aug. 1988); Form N-7 for Registration of Unit Investment Trusts under the Securities Act of 1933 and the Investment Company Act of 1940, Investment Company Act Release No. 15612 at text following n.1 (Mar. 9, 1987), 52 FR 8268 (Mar. 17, 1987); and SEC, Office of Investor Education and Advocacy, Unit Investment Trusts (UITs), available at http://www.sec.gov/answers/uit.htm.

523 With respect to UITs that are not ETFs and that do not serve as separate account vehicles that are used to fund variable annuity and variable life insurance products, broker-dealers have historically maintained a secondary market in UIT units. At present, based on Commission staff analysis of data as of December 2014, the Commission understands that approximately 75% of the assets held in UITs serve as separate account vehicles that are used to fund variable annuity and variable life insurance products, and the sponsors of these UITs do not typically maintain a secondary market in UIT units. See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Release No. 31835, 51-52 (Sept. 22, 2015), 80 FR 62273, 62289 (Oct. 15, 2015).

transfer agent rules.[524] One of the primary justifications for the Rule 17Ad-4(a) exemption was that at the time of adoption most equity securities at that time were issued in certificated form, while most mutual fund shares were uncertificated.[525] Thus, the Commission viewed the "redemption of fund shares" as being "significantly different from the transfer of ownership of stocks and bonds on the issuer's records."[526] However, today most equity securities are either immobilized at DTC or completely dematerialized and issued in book-entry form, potentially making the processing of securities issued by mutual funds and equity securities issued by operating companies more alike than different and raising the question of whether the Commission should consider amending or eliminating the Rule 17Ad-4 exemption.

Based on these and the other issues and developments discussed in this section and throughout this release, the Commission believes it is appropriate to consider whether new or amended rules governing transfer agents' services and activities with respect to mutual funds and other registered investment companies could be appropriate. Accordingly, the Commission seeks comment on the following:

101. What are the similarities and differences among transfer agents that service equity securities, debt securities, and registered investment company securities? Please explain.

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524 As noted above, Rule 17Ad-4(a) creates an exemption from Rules 17Ad-2, 17Ad-3, and 17Ad-6(a)(1)-(7) and (11) for interests in limited partnerships, DRIPs, and redeemable securities issued by investment companies registered under Section 8 of the Investment Company Act. See supra Section IV.A.2 for additional information regarding Rule 17Ad-4.

525 See supra Section IV.A.2.

526 Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145, at 32408; see also id. at n.13 ("[t]he amount of certificated fund shares is relatively small, and the amount of transfer agent activity in connection with transferring ownership of certificated shares represents a very small part of a transfer agent's activity with regard to an open-end investment company.").

102. Do transfer agents face different risks and challenges depending on the industry segment or asset class they service? Does the level of complexity associated with transaction processing by Mutual Fund Transfer Agents create risks or challenges the Commission should consider addressing? Why or why not? Please explain.

103. Should the Commission address specific issues related to Mutual Fund Transfer Agents and transfer agents that service other registered investment companies? Should the Commission, in regulating transfer agents to registered investment companies, take into account the trading, market, asset class, or other characteristics of the securities or issuers being serviced? What other factors, if any, should be considered and why? Alternatively, should the Commission regulate all transfer agents uniformly, regardless of the industry segment or asset class they service? Why or why not? What data should the Commission consider in making that determination? Please explain.

104. Should the Commission impose additional recordkeeping and disaster recovery requirements for Mutual Fund Transfer Agents? Why or why not?

105. Should the Commission require that transfer agents provide more detailed information on Form TA-2 about the type of issuers they are servicing and the types of work they are performing for those issuers? Why or why not? For example, should Form TA-2 include information regarding whether a transfer agent is servicing investment companies or pension plans? Why or why not? Would this information be helpful to issuers who seek specific skills or experience from their transfer agent? Should Form TA-2 require the disclosure of the name of each issuer serviced during the reporting period? Why or why not? What would be the benefits, costs, or burdens associated with any such requirements? Are there already freely available sources for this information? Please provide empirical data, if any.

106. As noted, transfer agent services for interests in limited partnerships, DRIPS, and redeemable securities of registered investment companies are exempt from certain turnaround rules under Rule 17Ad-4(a). In light of the expanded role of transfer agents in these areas, should the Commission eliminate these exemptions? If so, what costs, burdens, or benefits would accrue to investors, issuers, or the transfer agent industry? If these exemptions are not eliminated, should the Commission add other book-entry forms of ownership to the list of exemptions, including direct registration system positions, direct purchase plan positions, and employee purchase plans? Why or why not?

107. Are limited partnerships traded today in greater volumes than they were in 1977? Please provide empirical data. If so, do commenters believe the Commission should consider this as a potential basis for eliminating the exemption for transfer agents to limited partnerships in Rule 17Ad-4(a)? Why or why not?

108. In light of increased dematerialization, do commenters believe transfer agent processing of DRIP transactions today is largely similar to the processing of equity and debt securities? Why or why not? If so, do commenters believe the Commission should consider this as a potential basis for eliminating the exemption for transfer agents to DRIPs in Rule 17Ad-4(a)? Why or why not?

109. Transfer agents that service UITs are currently exempt under Rule 17Ad-4(a), but transfer agents that service closed-end funds are not. Should the Commission continue this distinction? Should the Commission apply transfer agent rules to transfer agents that service UITs in the same manner as the rules apply to transfer agents that service closed-end funds on the basis of historical similarities in the secondary market trading of both types of funds? Why or why not? Please explain.

110. Should the Commission amend the current transfer agent rules to explicitly address transfer agents for ETFs? Why or why not? How do transfer agent functions in connection with ETFs differ, if at all, from services transfer agents provide to other types of investment companies? Are there any particular issues unique to transfer agent service of ETFs that raise risks not present with respect to other types of investment companies? Please explain. If Rule 17Ad-4(a) is retained by the Commission in some form and is not proposed to be eliminated, should the Commission amend Rule 17Ad-4(a) to specify explicitly the applicability of its exemption to transfer agents to ETFs? If so, should transfer agents to ETFs be able to avail themselves of the exemption or should the exemption not apply to transfer agents to ETFs similar to the way in which the exemption today does not apply to transfer agents to closed-end funds, which in some cases are traded on national securities exchanges as are ETFs? Why or why not?

111. How are Mutual Fund Transfer Agents compensated today? Do any aspects of the structure or terms of their compensation raise regulatory concerns? Do Mutual Fund Transfer Agent fees based upon the fund's net assets create any conflicts of interest? Why or why not? If so, are there alternative fee structures that would not create conflicts of interest? Do Mutual Fund Transfer Agents provide fee rebates to issuers and, if so, do these raise any issues of regulatory concern? Do the internal and hybrid transfer agent models discussed above raise any special regulatory concerns? Why or why not? Please explain.

112. Should the Commission adjust its regulatory oversight of Mutual Fund Transfer Agents and, if so, how? Should any aspects of the Commission's regulatory regime for registered clearing agencies, including those that act as central securities depositories, apply to Mutual Fund Transfer Agents? Why or why not?

113. Given the increasing volume of transactions and activities facilitated through NSCC as the central clearance and settlement utility for mutual funds and intermediaries, what issues or concerns, if any, should the Commission consider

with respect to the various activities conducted through NSCC for mutual fund investors? Please describe.

114. How often do Mutual Fund Transfer Agents serve as fund administrators for the same mutual fund? Does this dual role create conflicts of interest for either the mutual fund or the Mutual Fund Transfer Agent? Does this dual role raise other concerns? If so, please describe.

115. What ancillary information or systems do Mutual Fund Transfer Agents or intermediaries rely on to ensure accurate processing and recordkeeping of mutual fund shares (e.g., master security/CUSIP databases, systems for tracking the age of fund shares for fee processing, cost basis systems for tax reporting)? Should the recordkeeping rules be modified or expanded to address such records? Please explain.

116. Transfer agents currently engage in the processing of "as of" transactions, or transactions which correct errors in the purchase or sale of mutual fund shares. What, if anything, differentiates, the "as of" transactions from an initial purchase or sale? Should the Commission specifically address "as of" transactions in transfer agent rules? Why or why not? Should the Commission adopt rules that govern which party, the mutual fund issuer or the Mutual Fund Transfer Agent, loses or retains profits resulting from processing errors when these errors are corrected by later "as of" transactions?

117. Mutual fund transfer agents facilitate the delivery of critical information (e.g., daily fund NAVs, dividend accrual information) to intermediaries for overnight batch processing of beneficial owner transactions. What issues or concerns, if any, should the Commission consider with respect to the timely delivery of such information, and the impacts of potential processing delays and downstream effects, including to investors? Please describe.

118. Should the Commission require that the number of "as of" transactions be reported by Mutual Fund Transfer Agents on Form TA-2? Why or why not? Are greater numbers of "as of" transactions indicative of potential processing problems at a Mutual Fund Transfer Agent, such as a turnaround backlog or problems with accuracy? Why or why not? Do greater numbers of "as of" transactions indicate potentially risky mutual fund trading practices that may dilute the interests of long-term investors in the mutual fund? Why or why not?

119. Does mutual funds' use of intermediaries who act as sub-transfer agents introduce new or additional risks to the prompt and accurate settlement of securities transactions? If so, what are those risks, should the Commission consider addressing those risks, and if so, how? Please explain.

120. Should the Commission propose rules governing how Mutual Fund Transfer Agents oversee sub-transfer agents to mutual funds? Why or why not? If so,

what rules should the Commission consider? Why, and what would be the benefits, costs, or other consequences of such rules? Please explain.

121. What oversight functions, if any, do Mutual Fund Transfer Agents typically perform for intermediaries performing sub-transfer agent or sub-accounting services to beneficial owners of mutual fund shares? What are the types of initial versus ongoing due diligence performed? What types of obstacles do Mutual Fund Transfer Agents face in performing the oversight function?

122. What problems, if any, are created by transfer agents' lack of visibility into the identity of beneficial owners and products serviced by intermediaries acting as sub-transfer agents? Please describe. If appropriate, could these issues be addressed solely by the Commission through revisions to the rules governing transfer agents? Would other regulatory changes be necessary, such as changes to the rules under the Investment Company Act or rules for broker-dealers under the 1934 Act (and 1933 Act)? Would other regulators also need to enact rule changes (for example, banking regulators and the Department of Labor for retirement plan recordkeepers) to assist with transparency?

D. Crowdfunding

Pursuant to the Jumpstart Our Business Startups (JOBS) Act ("JOBS Act"), the Commission adopted Regulation Crowdfunding on October 30, 2015.[527] These rules permit an issuer to raise up to $1,000,000 in a crowdfunding offering that is not registered under the Securities Act, subject to, among other things, certain caps on amounts individual investors may invest.[528] Crowdfunding offerings are offerings that are conducted primarily over the internet

527 See Crowdfunding, Securities Act Release No. 9974 (Oct. 30, 2015), 80 FR 71388 (Nov. 16, 2015) ("Crowdfunding Adopting Release"). In addition, pursuant to Section 401 of the JOBS Act, the Commission adopted amendments to Regulation A in March 2015. These amendments included a conditional exemption for securities issued in a Tier 2 offering under Regulation A from the mandatory registration requirements of Section 12(g) of the Exchange Act. One of the conditions of the exemption is that the issuer "[h]as engaged a transfer agent registered pursuant to Section 17A(c) of the Act to perform the function of a transfer agent with respect to...securities" issued in a Tier 2 offering pursuant to Regulation A. Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), Exchange Act Release No. 74578 14, 249, 285 n. 972 (Mar. 25, 2015), 80 FR 21805, 21809, 21820, 21867, 21879 n. 972 (Apr. 20, 2015), available at http://www.sec.gov/rules/final/2015/33-9741.pdf.; Exchange Act Rule 12g5-1(a)(7)(iii),17 CFR 240.12g5-1(a)(7)(iii).

528 See Regulation Crowdfunding Rule 100(a); Crowdfunding Adopting Release, supra note 527, at 71389.

through registered brokers or a new class of intermediaries, called "funding portals." The JOBS Act and Regulation Crowdfunding contain provisions that relate directly to transfer agents.

First, Regulation Crowdfunding created an exemption from the record holder count under Section 12(g) of the Exchange Act provided that certain conditions are met. One of these conditions is that "the issuer… has engaged the services of a transfer agent registered with the Commission pursuant to Section 17A of the Exchange Act."[529]

Second, under the JOBS Act and new Rule 501 of Regulation Crowdfunding, securities issued in crowdfunding offerings are subject to restrictions on resale for a period of one year, with the exception that they may be resold to other investors under specific conditions prior to the expiration of the holding period.[530] Regulation Crowdfunding does not mandate the use of a restrictive legend on crowdfunding securities certificates or book-entry security positions, but it does require the placement of a legend in the offering statement used in the offering.[531] Because of their experience in handling restricted securities, transfer agents retained by issuers in connection with crowdfunding offerings may be asked to track securities that were issued in

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529 The other conditions are that the issuer is current in its ongoing annual reports required pursuant to Rule 202 of Regulation Crowdfunding and has total assets as of the end of its last fiscal year not in excess of $25 million. See Crowdfunding Adopting Release, supra note 527, at 330, 662.

530 Securities Act Section 4A(e) provides that "Securities issued pursuant to a transaction described in section 4(6) may not be transferred by the purchaser of such securities during the 1-year period beginning on the date of purchase, unless such securities are transferred" under certain specified conditions. Rule 501(a) of Regulation Crowdfunding provides "Securities issued in a transaction exempt from registration pursuant to section 4(a)(6) of the Securities Act . . . and in accordance with section 4A of the Securities Act . . . and this part may not be transferred by any purchaser of such securities during the one-year period beginning when the securities were issued in a transaction exempt from registration pursuant to section 4(a)(6) of the Securities Act . . . unless such securities are transferred" under certain specified conditions, including that the transfer is to the original issuer, to an accredited investor, is part of a registered offering, or to a family member.

531 See Regulation Crowdfunding, Form C, Item 2, General Instruction III; see also Crowdfunding Adopting Release, supra note 527, at 68-69.

crowdfunding offerings and handle issues related to the restrictions on transfer and exemptions thereto.

Third, Rule 301(b) of Regulation Crowdfunding requires intermediaries to have a "reasonable basis" for believing that an issuer has established means to keep accurate records of the holders of the securities it would offer and sell through the intermediary's platform.[532] Intermediaries may rely on the representations of the issuer concerning its means of recordkeeping unless the intermediary has reason to question the reliability of those representations.[533] Rule 301(b), however, also provides a safe harbor for compliance for those issuers that use a registered transfer agent.[534]

As a result of these new provisions, transfer agents are likely to be involved in at least some crowdfunding offerings. Accordingly, the Commission seeks comment on the following:

123. What services, if any, do commenters anticipate transfer agents providing for crowdfunding issuers? How do commenters anticipate transfer agents will comply with their recordkeeping, safeguarding, and other requirements in the context of crowdfunding securities? Does the entry of transfer agents into the crowdfunding space pose new or additional risks for the prompt and accurate settlement of securities transactions? What are these risks, should the Commission address them, and, if so, how?

124. Transfer agents have traditionally assessed fees on a per shareholder basis. Do commenters believe transfer agents are likely to impose a per shareholder fee in connection with crowdfunding issuances? If so, is a per-shareholder fee appropriate? If not, what other kinds of fees are likely to be charged, and would they be appropriate?

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532 Regulation Crowdfunding Rule 301(b).

533 Id.

534 Id. ("An intermediary will be deemed to have satisfied this requirement if the issuer has engaged the services of a transfer agent that is registered under Section 17A of the Exchange Act . . .")

E. Administration of Issuer Plans

Many transfer agents provide transfer, recordkeeping, administrative, and other services related to certain types of issuer-sponsored plans that provide incentives to the issuer or securityholders in the form of reduced fees and commissions, as well as other benefits. These plans include DRIPs, DSPPs,[535] employee stock purchase plans ("ESPPs"),[536] equity-based incentive compensation plans,[537] odd lot programs,[538] and subscription rights programs (collectively, "Issuer Plans").[539] Many transfer agents also help administer employer-sponsored retirement plans ("Retirement Plans)." The specific services provided will vary depending on the nature of the plan or mutual fund and the agreement between the issuer and agent, but many are similar and can be thought of broadly as "Plan Administration"[540] services. Depending on the transfer agent and the specific services provided, some of these activities may raise broker-dealer registration issues. This section discusses these and other issues associated with transfer

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535 DSPPs allow individuals to purchase stock directly from the issuer or its transfer agent, again without going through a broker. Unlike DRIPs, investors do not need to be existing securityholders to participate in DSPPs.

536 ESPPs allow employees to invest in their employer's securities by purchasing shares directly from the employer (issuer) or its transfer agent, frequently at a discount to the market price.

537 Equity-based incentive compensation plans for example include plans regarding stock options, restricted stock units, and stock appreciation rights.

538 Odd-lot program are used by issuers to purchase shares of their own stock back from owners of less than 100 shares (a 100 share block is considered to be a "round lot"), which may reduce the issuer's transfer agent and other fees by reducing the number of registered stockholders and/or allow small investors to sell their stock without a broker. The Commission staff has provided no-action relief to a transfer agent in connection with its participation in an odd-lot program and charging of fees to investors (that were estimated to be lower than standard broker commissions) without requiring registration of the transfer agent as a broker-dealer. See American Transtech Inc., SEC Staff No-Action Letter (Sept. 22, 1985).

539 Subscription rights programs allow existing stockholders to avoid dilution of their percentage ownership by purchasing enough shares in the issuance to retain at least the same level of percentage ownership.

540 "Plan Administration" and "Administration," as used in this release are not terms of art with a fixed definition. We use them broadly as simplified shorthand to refer to some of the services discussed herein.

agents' Plan Administration activities and seeks comment regarding possible regulatory actions regarding those issues.

### *1. Third Party Administrators*

The majority of Plan Administrators that provide services for Retirement Plans (and some Issuer Plans and mutual funds) do not perform statutory transfer agent functions,[541] and therefore may not be required to register as a transfer agent with the Commission or other ARA. Because they are generally hired by the Retirement Plan or other plans rather than the issuer, in this context, Plan Administrators may be referred to as Third-Party Administrators ("TPAs").[542] It is the Commission staff's understanding that the majority of TPAs are not registered as transfer agents, although some do so voluntarily.

One of the TPA's main responsibilities is acting as an intermediary between benefit plan participants and the plan. For example, TPAs provide various services when enrolling new employees in a company's benefit plan, including recording and processing their enrollment and collecting information about their funding and investing preferences (e.g., fund allocations). TPAs use this information to generate payroll deduction instructions and transmit these instructions to the participant's payroll or human resources department for processing.

TPAs continue to act as intermediaries between the benefit plan participants and plans after participants enroll in the plan. For example, if participants wish to transfer or reallocate mutual funds within their plan, they submit their request to the TPA, which will process and

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541 See supra note 139 and Section IV.A for a description of the specific activities which require registration as a transfer agent under the Exchange Act.

542 The term "TPA" is used here to refer generally to a broad category of "administrators" who provide the types of services described herein.

record these requests and provide the transactional details to the plan trustee or investment manager. Similarly, when participants request a payment, the TPA may send the transaction details to the NSCC, plan trustee, and investment manager, and provide payment instructions to the mutual fund and Mutual Fund Transfer Agent. In addition to processing transactions, TPAs may provide participants with customer service support, activity statements, and other communications.

TPAs may also provide sub-transfer agent services for plans that offer, as investment options of the plan, investment in the shares of mutual funds.[543] In this arrangement, TPAs take orders from investors and perform record consolidation services as sub-transfer agents to the plan. Instead of submitting to mutual funds (and their Mutual Fund Transfer Agents) hundreds or thousands of individual purchase and redemption orders each day in the shares of those mutual funds that have been submitted to the plan (and its TPA) by individual plan participants, TPAs may aggregate and, in some instances, net orders on behalf of the plan to be submitted to a mutual fund.[544] Orders are aggregated by adding all of the purchase and redemption orders for a particular mutual fund and submitting the total purchase order and the total redemption order to the mutual fund.

Once aggregated, TPAs may go a step further and create a single net order by offsetting the purchase and redemption orders against each other. These services allow TPAs to complement the administrative and recordkeeping services they already provide to plans and

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543 For additional discussion of sub-transfer agent services, see supra Section VII.B

544 See, e.g., comment letters to Investment Company Act Release No. 26288 (Dec. 11, 2003), 68 FR 70388, 70388-89 (Dec. 17, 2003), available at http://www.sec.gov/rules/proposed/s72703.shtml.

possibly earn additional fees from mutual fund complexes. They also reduce the amount of transactions that mutual fund complexes (and their Mutual Fund Transfer Agents) need to process. Under this arrangement, the mutual fund often does not know the identity of the plan participants since TPAs, not the mutual funds, are taking the orders directly from the plan participants and submitting orders to the mutual funds on behalf of and generally in the name of the plan.[545] In these situations, the Mutual Fund Transfer Agent would know only the plan, which is the legal owner of the shares of the mutual fund held by the plan for the benefit of its participants.

### 2. *Issuer Plans*

Issuers commonly appoint Plan Administrators to administer their Issuer Plans. Depending on the type of security being serviced and the scope of the activities performed, Plan Administrators may be required to register with the Commission or other ARA as a transfer agent.[546] For simplicity and because of the pre-existing relationship, issuers may simply hire their existing transfer agent.

Plan Administrators perform primarily four tasks for these plans. First, they handle communications with investors, including their initial plan registration,[547] often by operating a website that allows investors to sign up for and manage their account.

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545 See supra note 506 and accompanying text for a discussion of Investment Company Act Rule 22c-2, the provision of taxpayer identification numbers to assist mutual funds in complying with rules related to "forward pricing," and transfer agent services that assist mutual funds in complying with Rule 22c-2.

546 For additional discussion of transfer agent registration requirements, see supra Section IV.A.

547 Many DRIPs require investors to own at least one share registered in their name (as opposed to being held in street name) before they will be allowed to participate in the DRIP.

Second, they purchase company shares for the plan,[548] typically on the secondary market, although purchases can also be made through negotiated transactions or from the company itself, for example by using authorized but unissued shares of common stock or shares held in the company's treasury.[549] Some issuers offer investors who participate in their plans discounts on the share price, but there is wide variation in how this is offered.

Third, Plan Administrators maintain custody of purchased shares on the participants' behalf,[550] with the purchased shares typically being registered in the name of the transfer agent's nominee. This could lead to plan participants holding the issuer's shares in two places: their bank or brokerage firm for the original registered shares, and the Plan Administrator for shares purchased through a plan. To address this, many Plan Administrators allow Plan participants to deposit their original registered shares into the participant's DRIP account for safekeeping at no charge or for a modest fee. Once deposited with the transfer agent, the shares are treated the same way as the other shares in the participant's account.

Finally, Plan Administrators maintain Plan records and send regular account statements and other communications to plan participants. These typically include quarterly account statements and transactional statements after each cash investment, transfer, deposit, withdrawal,

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548 When investors join a plan, they are typically required to sign a document authorizing the agent to make purchases on their behalf.

549 Plan Administrators typically purchase shares on or around the dividend payment date, but they may spread out large purchases made on the secondary market over a longer period of time to avoid affecting the share price. When purchasing shares on the secondary markets, the share price is generally determined by averaging the price of all shares purchased for that investment period; when purchased directly from the company, it is based on an average of the high and low or the closing price for the stock as reported by a specified source.

550 Paper certificates for shares of the company's common stock purchased under the plans will generally not be issued unless requested by the participant. Paper certificates are also issued when a participant no longer wants to participate in the plan.

or sale. These statements generally show cash dividends and optional cash payments received, the number of shares purchased, the purchase price for the shares, the total number of shares held for the participant, and an accumulation of the transactions for the calendar year to date. In addition, Plan Administrators send plan participants the same communications that are sent to every other securityholder of the company's common stock, including the company's annual report, annual meeting notices, proxy statements, and income tax information for reporting dividends paid by the company.

### 3. *Potential Broker-Dealer Registration Issues*

As described above, Plan Administrators, TPAs, and Mutual Fund Transfer Agents all provide some level of transaction execution and order routing services. The specific services may vary depending on the plan or firm, but in general, administrators that provide transaction execution services will handle customer funds and securities and may provide some level of netting, which is the process of offsetting expected deliveries and payments against expected receipts in order to reduce the amount of cash and securities to be moved. For example, some administrators for employer-sponsored retirement plans offset purchase and sale transactions in the same target mutual fund by different participants in the plan and submit a net order to the transfer agent of the mutual fund. Netting is a function commonly performed by clearing agencies and may also be performed by broker-dealers for customers holding in street name, but is not among the core functions enumerated in Exchange Act Section 3(a)(25) performed by registered transfer agents. Hence, netting and other execution services may not themselves implicate transfer agent requirements, but nonetheless may trigger broker-dealer regulatory requirements.

The Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others"[551] and requires non-exempt brokers to register with the Commission.[552] "Effecting securities transactions" includes, among other things, identifying potential purchasers of securities, soliciting securities transactions, routing or matching orders, handling customer funds or securities, and preparing and sending transaction confirmations (other than on behalf of a broker-dealer that executes the trades).[553] Receiving transaction-based compensation may also indicate that a person is effecting securities transactions for the account of other.[554]

The Commission has brought enforcement actions against transfer agents operating as broker-dealers without registering as such with the Commission. For example, the Commission found that a transfer agent was acting as an unregistered broker-dealer in violation of Exchange Act Section 15(a) when it, among other things: opened accounts for individual retirement account ("IRA") customers; established an interest bearing depository account to receive IRA customer monies; had a power of attorney to withdraw, deposit and transfer IRA customer funds held by custodial banks, and to purchase assets in the name of the custodian; charged IRA customers a transaction fee when IRA customers made a purchase or sale of securities through a

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551 Exchange Act Section 3(a)(4)(A), 15 U.S.C. 78c(a)(4)(A).

552 Exchange Act Section 15(a)(1), 15 U.S.C. 78o(a)(1). Exchange Act Section 3(a)(4)(B), 15 U.S.C. 78c(a)(4)(B), provides an exception to the definition of "broker" for certain bank activities.

553 Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Exchange Act Release No. 44921, 66 FR 27760, 2772-3 (May 18, 2001).

554 See, e.g., SEC v. Margolin, 1992 WL 279735, at *5 (S.D.N.Y. Sept. 30, 1992) (ruling that Commission had demonstrated a substantial likelihood of success on the merits of its claim that a person was acting as an unregistered broker where the defendant "provided clearing services" for many transactions, "receiv[ed] transaction-based compensation, advertis[ed] for clients, and possess[ed] client funds and securities.")

broker-dealer or issuer; prepared periodic account statements for IRA customers; and physically held certain IRA customers' securities in its office vault.[555] Furthermore, a transfer agent that effects securities transactions for investors in connection with administering certain types of Issuer Plans may be engaging in broker activity.[556]

The Commission staff has stated its view that it will not recommend enforcement action where a TPA performs some "clerical and ministerial" activities without registering as a broker, subject to the conditions that, among things, the TPA refrain from netting or matching orders.[557] This guidance is consistent with long-standing views on what constitutes broker activity.[558] The Commission also notes that its staff has taken the position in connection with no-action relief that, depending on the facts and circumstances, the performance of some or all of the administrative activities discussed in this section are also performed by entities that have registered with the Commission as brokers for such purposes.[559] Transfer agents that solicit

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555 In the Matter of Bankers Pension Services, Inc., Exchange Act Release. No. 37567 (Aug. 14, 1996) (settled action). See also In the Matter of Transcorp Pension Services, Inc., Exchange Act Release No. 37278 (Jun. 4, 1996) (finding a transfer agent acted an unregistered broker-dealer for engaging in similar conduct).

556 In the Matter of CIBC Mellon Trust Company, Exchange Act Release No. 51291 (Mar. 2, 2005); In the Matter of Computershare Trust Company of Canada, Exchange Act Release No. 53668 (Apr. 18, 2006).

557 See Universal Pensions, Inc., SEC Staff No-Action Letter 25 (Jan. 30, 1998) (applicant letter noting that "the SEC staff has previously agreed that broker registration is not required for persons who perform 'clerical and ministerial' services similar to services provided by the TPA."); see also Urratia, Carlos M., SEC Staff No-Action Letter (Aug. 27, 1980); Investment Company Institute, SEC Staff No-Action Letter (June 13, 1973); Applied Financial Systems, SEC Staff No-Action Letter (Sept. 25, 1971); Dreyfus Group Equity Fund, SEC Staff No-Action Letter (June 26, 1971) ("No Action Letters").

558 See generally, Louis Loss, Joel Seligman, and Troy Paredes, Securities Regulation, § 8(A)(3) (2007); David A. Lipton, Broker-Dealer Regulation, Vol. 15, § 1:6 (2006).

559 See, e.g., No-Action Letters, supra note 557 (regarding condition that the recipients of the letters refrain from executing orders).

purchase and sale orders, accept orders directly from investors, advertise services directly to investors, and make investment recommendations, also raise broker-dealer registration issues.[560]

### 4. *Discussion and Request for Comment*

The Commission is generally requesting comment on whether new rules may be appropriate to bring greater clarity, consistency, and regulatory certainty to Plan Administration and similar activities by entities registered with the Commission solely as transfer agents as well as by entities that may not be registered with the Commission in any capacity.[561] Specifically, the Commission requests comment on the following:

125. Exchange Act Rule 17Ad-9(m) describes various transfer agent functions that are broader than the five statutory functions defined in Exchange Act Section 3(a)(25). Likewise, as discussed in this and other sections, modern transfer agents perform a wide array of services and functions that do not fall within the confines of Section 3(a)(25) and are not otherwise identified or contemplated in the existing transfer agent rules. Should the Commission update the transfer agent rules to address additional transfer agent services and functions that do not fall within the confines of Section 3(a)(25)? Why or why not?

126. Should the Commission impose supervisory obligations on entities engaged in transfer agent activities, such as transfer agents and plan administrators, such as requiring that employees be properly trained, comply with continuing education requirements, and adhere to regulations and company policies? Why or why not?

127. Definitions in Rules 17Ad-1 and 17Ad-9 do not explicitly apply to all types of transactions and functions related to Issuer Plans, investment company securities,

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560 See, e.g., SEC v. Deyon, 977 F. Supp. 510 (D. Me. Aug. 27, 1997) (two unregistered defendants violated Section 15(a) of the Exchange Act by, among other things, soliciting investors by phone and in person); SEC v. Century Inv. Transfer Corp., Fed. Sec. L. Rep. (CCH) 93,232 (S.D.N.Y. Oct. 5, 1971) (defendant was engaged in the broker-dealer business by, among other things, advertising in the Wall Street Journal to solicit customers); SEC v. Corporate Relations Group, Inc., 2003 WL 25570113 (M.D. Fla. Mar. 28, 2003) (defendant acted as an unregistered broker when it actively sought investors, recommended securities to investors through registered representatives, and provided its broker relations executives with transaction-based compensation for stock sales).

561 As noted, depending on the type of securities being administered and the scope of administration services being performed, an entity may or may not be required to register with the Commission in the capacity of a transfer agent and/or a broker-dealer.

restricted securities, and corporate actions, or to all transactions relating to book-entry activity and DRS transactions. For example, the rule does not specify that "credit" and "debit" include Issuer Plan transactions and book-entry accounts as well as investment company securities transactions. Does the lack of specificity cause difficulties in providing services relating to those areas not specifically enumerated? Why or why not?

128. Does Rule 17Ad-2 create uncertainty concerning the applicability of the rule to activities related to Issuer Plans, investment company securities, restricted securities, and corporate actions? If there is such uncertainty, how does it impact transfer agents' functionality? Are issuers concerned about impacts on service levels? If so, please describe.

129. The recordkeeping requirements in Rule 17Ad-6 do not specifically include activities associated with investment company securities, Issuer Plans, DRS transactions, paying agent activities, or corporate actions. Are transfer agents applying the rule's recordkeeping requirements to these activities? If not, what would be the additional cost, benefits and/or burdens, if any, in doing so? Please describe.

130. Rule 17Ad-10 does not specifically address activities performed by many transfer agents, such as Plan Administration, paying agent activities, or corporate action recordkeeping. Does this create any obstacles to complying with the rule, such as by creating confusion or uncertainty? Why or why not? Please explain.

131. There are no Commission regulations addressing plan enrollment practices, such as negative consents or automatic enrollments. What risks, if any, arise from these enrollment methods? Should the Commission address any such risks? Why or why not? If, so how?

132. To ensure that transfer agents make and keep comprehensive records relating to all of their activities, should the Commission address records related to Issuer Plan and mutual fund activities? Why or why not? For example, should transfer agents be required to make and maintain records of orders for the purchase or sale of Plan or mutual fund securities in a manner similar to that required of broker-dealers? Why or why not? Should they be required to create and maintain records relating to reconciliations with custodial accounts and order-submitting entities? Should they be required to make and maintain specific records relating to plan participants? Why or why not? Please explain and provide supporting evidence regarding any potential effects. To the extent that any data, records, and/or other information that such rules might require to be made and preserved are prepared and maintained by an outside party on the transfer agent's behalf, should the Commission require that the outside entity file a signed, written undertaking with the Commission to the effect that such records are the property of the transfer agent and will be surrendered promptly on request of the transfer agent and subject to examination by the Commission or other ARA? Why or why

not? Please explain and provide supporting evidence regarding any potential effects.

133. Should the Commission amend the rules so that transfer agents performing specific activities are exempt from broker-dealer registration only if they are (i) registered with the Commission as a transfer agent, (ii) limit their activities to those specified in the general rule, and/or (iii) agree to abide by certain other conditions designed to protect investors and limit the risks associated with those activities? Why or why not? Should the Commission require broker-dealer registration for any activities beyond what is permitted or conducted by an entity that is not registered with the Commission as a transfer agent under such an exemption? Why or why not? Please explain and provide supporting evidence regarding any potential effects.

134. Do commenters have any concerns about TPAs who voluntarily register with the Commission as transfer agents, but do not provide statutory transfer agent services as defined by Exchange Act Section 3(a)(25)? Why or why not? Should the Commission prohibit TPAs who do not perform statutory transfer agent functions as defined by Exchange Act Section 3(a)(25) from voluntarily registering with the Commission as transfer agents? Alternatively, should the Commission deny transfer agent registration applications or revoke registrations of TPAs that do not provide statutory transfer agent services as defined by Exchange Act Section 3(a)(25)? Why or why not? Please explain and provide supporting evidence regarding any potential effects.

135. Do commenters have any concerns regarding the activities or business practices of TPAs that are not registered with any federal financial regulator? If so, what actions, if any, should the Commission consider taking to address these concerns? Please explain and provide supporting evidence regarding any potential effects.

136. What risks, if any, do commenters believe are posed by the enrollment and purchase and sale activities of transfer agents with respect to Issuer Plans and registered investment companies? What, if anything, should the Commission do to address such risks and why? For example, would rules focusing on risk management address any risks associated with transfer agents' current role in the purchase and sale of securities? Please explain and provide supporting evidence regarding any potential effects. Are there additional Issuer Plan activities or services provided by transfer agents, Plan Administrators, or other entities that are not described in the release? If so, what are they?

137. Should the Commission conditionally exempt from broker-dealer registration transfer agents that effect orders to purchase or sell securities in connection with their servicing of Issuer Plans? If so, what conditions, if any, should apply to that exemption? Should they be subject to net capital or customer protection requirements to guard against the risks of mishandling investors' funds or securities? What regulations, if any, should the Commission propose to safeguard

investor privacy? Does the Issuer Plan business necessitate different books and recordkeeping requirements? If so, how should the Commission amend its books and recordkeeping requirements? Should the Commission's rules require the personnel of Issuer Plan transfer agents who interact with Issuer Plan investors, such as call center representatives, to be subject to registration, licensing, training, or continuing education requirements? Should transfer agents for Issuer Plans be permitted to net customer buy and sell orders? Why or why not, and if so, under what conditions? Should transfer agents be required to hold the funds of Issuer Plan securities in a bank account for the exclusive benefit of investors? Why or why not? Under what circumstances should a transfer agent or its personnel be disqualified from effecting transactions on behalf of Issuer Plans? Should transfer agents be permitted to receive payment for order flow in connection with Issuer Plan transactions? Why or why not? What rules might help to ensure the integrity of the master securityholder file in cases where a transfer agent servicing the Issuer Plan is not the recordkeeping transfer agent?

138. What fees are being charged today by transfer agents directly to investors or indirectly to investors (such as through transaction fees in connection with Plan Administration activities that are comparable to broker commissions or dealer markups)? Should the Commission require transfer agents to clearly and concisely disclose fees charged to the investor? Do fees charged to investors by transfer agents or by sub-transfer agents encourage or deter investor decisions regarding their form of ownership (e.g. the investor decision to hold in DRS, the investor decision to request a certificate, or the investor decision to hold in registered versus street name)? If these fees influence investor decision-making, is the aggregate effect on this influence good or bad for: (i) the protection of investors and (ii) continued improvement in the promptness and efficiency of the National C&S System? What is the available evidence?

139. Investors who transact with or through a broker-dealer receive confirmations pursuant to Rule 10b-10. However, investors holding securities positions directly with a transfer agent in DRS, in an Issuer Plan or other program administered by a transfer agent, or in a mutual fund that attracts self-directed investors, do not always receive comparable information from the transfer agent. Should the Commission require transfer agents to provide written communication to a securityholder with details about a transaction within a set time period? Why or why not? Are there other approaches the Commission could consider to ensure that investors are informed about their transactions on a timely basis? If so, please describe.

140. While transfer agents may be authorized by an issuer to assist with the enrollment process for plan participants, it may not be clear whether investors have initiated the enrollment or whether the transfer agent solicited the transaction. Similarly, while transfer agents may assist with securityholder inquiries, it may not be clear whether agents in so doing may, inadvertently or not, solicit securityholders for purchase or sale activities. What controls, if any, do transfer agents put in place

to prevent solicitation? Do commenters believe those controls are effective? Why or why not? Should the Commission impose additional or different controls? Why or why not? Please explain.

F. Outsourcing Activities and Non-Qualifying Securities Serviced by a Registered Transfer Agent

As noted, the transfer agent rules established by the Commission are designed not only to ensure that transfer agents meet prescribed performance standards for their core recordkeeping and transfer activities, but to ensure they are regulated appropriately in the context of the National C&S System[562] and that any problems meeting these performance standards do not negatively impact individual investors or the National C&S System as a whole.[563] Today, some transfer agents maintain offices and provide services outside the United States, and almost all transfer agents provide an array of services, including for non-Qualifying Securities. Other transfer agents may outsource some of their activities or operations to outside entities. For example, some registered transfer agents rely on outside entities to provide data hosting or specific IT services, perform data entry, or provide call center services. While the Commission believes the consistent application of the transfer agent rules to all activities of registered transfer agents is critical to protect investors and promote the safe and efficient functioning of the National C&S System, we also are mindful that applying the transfer agent rules uniformly to all

562 See Rule 17Ad-1 through 17Ad-7 Adopting Release, supra note 145 (noting the importance of avoiding impediments to "the Commission's efforts to provide necessary or appropriate regulations for transfer agents in the broader context of the establishment of a national system for the prompt and accurate clearance and settlement of securities transactions.").

563 Id. (Exchange Act Rule 17Ad-3 prohibits transfer agents from taking on new or additional business in certain circumstances where they fail to meet their performance standards over certain time periods, in part, because "it is not in the public interest or consistent with the protection of investors for a transfer agent which is unable to perform its current obligations in a timely manner to take on additional responsibilities.")

securities serviced by those transfer agents could: (i) increase costs above those that would be incurred if the transfer agent rules applied only to Qualifying Securities; (ii) create conflicts with the laws of the other jurisdictions in which a transfer agent operates;[564] or (iii) impact transfer agents in other ways.

Accordingly, the Commission seeks comment on the following:

141. What activities do transfer agents outsource, domestically or foreign, and why? Does the outsourcing of these activities present risks or raise other issues? What is the empirical evidence? What regulations, if any, should the Commission impose to address these risks? For example, should the Commission require outsourcing arrangements to be memorialized in a written agreement detailing the allocation of responsibilities? Why or why not? If such a written agreement were required, should the Commission require some or all records associated with the performance of the agreement to be considered records of the registered transfer agent and therefore subject to inspection by the Commission? Why or why not? Should outsourcing arrangements be disclosed in Form TA-2? Why or why not? Should the Commission apply different standards or different rules to transfer agents who use or engage in outsourcing activities? If so, what standards should apply, and why? Please identify any tradeoffs, including any costs and benefits that the Commission should consider. Please also provide supporting empirical evidence, if available.

142. Are there non-U.S. regulations governing transfer agents operating outside the United States that commenters believe the Commission could use as a model for similar regulations in the United States? If so, why, and how do these regulations serve the public interest in the jurisdictions in which they apply? If the Commission were to consider similar regulations, in what ways should such regulations be tailored to operations in the U.S. securities markets? What tradeoffs should the Commission consider in evaluating the alternatives?

143. Should the Commission's transfer agent rules apply with equal force to U.S. and non-U.S. transfer agents (or non-U.S. subsidiaries of U.S.-based transfer agents) that provide transfer-related services for Qualifying Securities? Why or why not?

144. Should the Commission codify existing staff interpretations stating that registered transfer agents that service at least one Qualifying Security must apply all of the

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564 For example, the privacy laws of some foreign jurisdictions may not permit the fingerprinting required under Rule 17f-1.

transfer agent rules to all securities serviced by that transfer agent, including non-Qualifying Securities? Alternatively, should the Commission provide exemptions regarding non-Qualifying Securities from one or more or from all of the Commission's transfer agent rules? Why or why not? If so, what exemptions would be appropriate, and why? How would any such exemptions protect investor funds and securities, ensure the safe and efficient functioning of the National C&S System, and ensure appropriate oversight by regulators of transfer agents and the entities that perform services on their behalf?

145. Are there technological, legal, policy, or other reasons why a registered transfer agent would not be able to apply the transfer agent rules to all securities serviced by the transfer agent? Why or why not? If so, should the Commission provide exemptions to address such issues, and what should such exemptions provide?

146. Do transfer agents typically have access to or control over records created or held by sub-contractors?[565] If so, are those records part of the records that transfer agents provide to the Commission in response to requests? Why or why not?

147. Do other transfer agent activities, such as operating call centers, present investor protection or other concerns? How are call center employees supervised? How are call center employees trained on applicable federal securities law and legal documents that may govern or affect the issuer, for example policies and procedures of the issuer and, for certain types of issuers, prospectus limitations? Are risks greater if these securityholder services are conducted by offshore call centers?

148. Should the Commission impose additional recordkeeping, processing, and transfer rules on outside entities retained by transfer agents to address concerns that third-party firms may pose a risk to investors and the National C&S System? If so, should those rules apply to foreign firms that are engaged in services for U.S. issuers? Why or why not?

149. As noted, both Reg SDR and Reg SBSR may permit, in certain circumstances, substituted compliance for foreign participants and registrants. Should the Commission take a similar approach to regulating non-U.S. transfer agents? Why or why not?

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565 Regarding sub-contractor relationships, see generally, Section VII.C.1.

G. Additional Request for Comment

We are also interested in more generalized concerns related to transfer agents and any other issues that commenters may wish to address relating to transfer agents. For example, we seek comment on how the role of transfer agents may continue to evolve, and what regulatory challenges these changes may pose. Please be as specific as possible in your discussion and analysis of any additional issues. In connection with comments, we also welcome comments that respond to requests for comment or of their own accord, and/or suggest specific amendments or new additions to the transfer agent rules including draft rule text. We also request commenters to provide any specific, detailed data and information related to potential or actual costs and benefits associated with any of the suggested reforms, changes, or amendments discussed throughout this release. Accordingly, the Commission seeks comment on the following:

150. Do the transfer agent rules accomplish the Commission's regulatory objectives of protecting investors, promoting the prompt and accurate clearance and settlement of securities transactions, and evaluating transfer agents' ability to perform their functions properly? Why or why not? Please provide a full explanation.

151. Do the current transfer agent rules adequately address the interests of issuers? If not, in what ways do they not address issuers' interests and should they? Why and in what way?

152. Do the current transfer agent rules adequately address the interests of other market participants? If not, in what ways do they not address those interests and should they? Why and in what way?

153. Some of the original transfer agent rules established metrics-based performance standards designed to measure the transfer and processing of paper certificates. Given the prevalence of electronic transactions, do those metrics-based performance standards adequately address transfer agents' operational capabilities, which now largely depend on systems and technology that did not exist when the original rules were adopted in 1977? Should the Commission rely on a different or additional approach to regulating transfer agents, such as a risk-based approach focused on the risks associated with specific activities or conduct? Please provide a full explanation.

154. In what ways do the activities performed and services provided by transfer agents differ depending on the type of issuer, asset class, product category, market segment, or other factors the transfer agent is servicing? For example, are there differences in activities, services, or other areas between issuers that act as their own transfer agent and independent transfer agents? If so, what are those differences? Do a transfer agent's processes differ if the transfer agent is servicing debt securities instead of equity securities? If a transfer agent primarily services debt securities, do the transfer agent's processes differ depending on the specific type of debt security being serviced (e.g., corporate, asset-backed, etc.)? Are there differences in services provided, compensation arrangements, or other areas between or among different types of transfer agents? If so, what factors influence or affect those differences? Do transfer agents tend to service one type of issuer, asset class, or market segment to the exclusion of others? If so, what factors influence that focus and why? Please explain.

155. Do commenters believe that transfer agent servicing of debt securities raises different issues or concerns than those raised by servicing of equity securities? Do commenters believe there are specific risks or issues related to transfer agents' servicing of debt issues that are not addressed by existing Commission transfer agent rules? Are there differences in agreements that equity transfer agents enter into with issuers as compared to transfer agency agreements between debt transfer agents and issuers, including differences in services to be provided, methods of compensation, or any other topics?

156. Should the Commission propose different rules for different types of transfer agents depending on the particular issuer type, asset class, or market segment serviced by the transfer agent? Why or why not?

157. What fees do transfer agents assess with respect to processing DRS instructions? How and to whom are such fees assessed? Do commenters believe the Commission should consider regulating such fees in some manner? If so, why and how? Please explain.

158. Do transfer agent fees vary, depending upon the asset class of the security serviced by the transfer agent? If so, how do they vary? To what extent does competition among transfer agents constrain such fees, and what is the evidence? Should the Commission require that any such fees be fair and reasonable? Why or why not? Please provide a full explanation.

159. To what extent are co-transfer agents used in securities processing today? Should the Commission amend its rules with respect to co-transfer agents?

160. What, if any, are the problems in the marketplace today with respect to the role of transfer agents and corporate actions? Should the Commission propose rules governing transfer agent services provided in connection with corporate actions? Why or why not? If so, which types of services provided in connection with

corporate actions should the Commission consider regulating?

161. Should the Commission propose rules requiring standardized corporate actions processing as a method to facilitate communications among market participants? Why or why not? If so, what are the primary market issues that such a standardization program is likely to address? Would there be any market issues that such a standardized program would not be able to address? Please explain.

162. What, if any, are the risks posed by transfer agents' role when they serve as: (i) tender agent; (ii) subscription agent; (iii) conversion agent; or (iv) escrow agent? Do commenters believe rules governing transfer agent services provided in connection with these services would be appropriate? Why or why not? If so, what regulatory action should the Commission consider to address those concerns and why?

163. Do commenters believe there are any concerns that might arise from regulation of the proxy tabulation process generally and the transfer agents' role in the proxy process in particular? If so, what regulatory action, if any, should the Commission consider to address those concerns and why?

164. Is the role that transfer agents play in the proxy process useful for efficient, accurate, and timely communications between issuers and their securityholders? In light of comments previously received by the Commission in connection with its concept release concerning the proxy process, are there additional concerns regarding consolidation in the market? If so, please describe any such concerns.

165. In connection with considerations of transfer agents' role within the National C&S System, do commenters believe the creation of an SRO for transfer agents would be useful or appropriate? Why or why not? If so, what should the scope of the purview of such an SRO be, and what should the SRO be tasked with? Please explain.

166. Do commenters believe the introduction of certain alternatives to the current central securities depository model, such as a modified transfer agent depository, could be beneficial to issuers, securityholders, and/or the National C&S System? Why or why not? Could it co-exist with the current central depository system? Why or why not? What would such a modified depository entail or look like?

167. Some observers have commented that current DTC requirements, such as those related to DRS and FAST, operate as so-called *de facto* regulation of transfer

agents by DTC.[566] Is this accurate? If so, do such DTC requirements create inconsistencies and/or conflicts for transfer agents to comply with all rules and requirements? Why or why not? If yes, please describe the inconsistencies and/or conflicts. Should the Commission adopt any of DTC's current requirements or standards that apply to transfer agents who conduct business with DTC as rules? Why or why not? If so, what requirements or standards should be considered, and why?

168. Should the Commission propose any other amendments to the transfer agent rules that are not discussed above? If so, please describe what amendments should be considered and why, including any information on the benefits, risks, and/or burdens of any suggested approach.

169. How might the transfer agent industry continue to evolve in the future, and what challenges might that evolution pose for the regulatory structure? What regulatory issues and other challenges are posed by the industry's increasing concentration and specialization? What does the decline in the number of registered securityholders mean for the industry, and for the regulatory regime? Do commenters believe that, as dematerialization progresses, the role of transfer agents to operating companies will change? If so, will it converge with that of Mutual Fund Transfer Agents? If so, what are the possible implications of this?

170. Are there any other issues that commenters may wish to address relating to transfer agents? Please provide a full explanation.

By the Commission.

Brent Fields

Secretary

December 22, 2015

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566 See Securities Exchange Act Release No. 60196 (June 30, 2009), 74 FR 33496 (File No. SR-DTC-2006-16) (specifically, comment letter from Martin (Jay) J. McHale, President, U.S. Equity Services, Computershare, Mar. 20, 2008; comment letter from Charles V. Rossi, President, Securities Transfer Association, June 22, 2007; comment letter from Gary N. Nazare, Managing Director, Transfer Agency Services, The Bank of New York, June 29, 2007).

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

**December 23, 2015**

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| **In the Matter of**<br><br>**Yayi International, Inc.,**<br><br>**File No. 500-1** | **ORDER OF SUSPENSION OF TRADING** |

It appears to the Securities and Exchange Commission ("Commission") that there is a lack of current and accurate information concerning the securities of Yayi International, Inc. ("YYINE[1]") (CIK No. 789860), a void Delaware corporation whose principal place of business is listed as Zhongbei Town, Xiqing District, Tianjin, China because it is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended December 31, 2011. On April 22, 2015, the Commission's Division of Corporation Finance sent a delinquency letter to YYINE at the address shown in its then-most recent filing in the Commission's EDGAR system requesting compliance with its periodic filing requirements. To date, YYINE has failed to cure its delinquencies. As of December 15, 2015, the common stock of YYINE was quoted on OTC Link operated by OTC Markets Group, Inc. (formerly "Pink Sheets") had seven market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

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

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 December 23, 2015, through 11:59 p.m. EST on January 7, 2016.

By the Commission.

Brent J. Fields
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. 76747 / December 23, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17025**

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| **In the Matter of**<br><br>**Yayi International, Inc.,**<br><br>**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 the respondent named in the caption.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT [1]

1. Yayi International, Inc. ("YYINE") (CIK No. 789860) is a void Delaware corporation located in Zhongbei Town, Xiqing District, Tianjin, China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). YYINE is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 10-QSB for the period ended December 31, 2011, which reported a comprehensive loss attributable to common shareholders of $4,093,796 for the prior nine months. As of December 15, 2015, the common stock of YYINE was quoted on OTC Link operated by OTC Markets Group, Inc. (formerly "Pink Sheets") had seven market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

B. DELINQUENT PERIODIC FILINGS

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely periodic reports and failed to bring its filings current in response to the delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations.

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

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

**III.**

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

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or 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 the Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, 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 the Respondent 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.

Brent J. Fields
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. 76751 / December 23, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17026**

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| **In the Matter of**<br><br>**Easylink Information Technology Co., Ltd.,**<br><br>**Respondents.** | **ORDER INSTITUTING ADMINISTRATIVE PROCEEDING 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 a public administrative proceeding be, and hereby is, instituted pursuant to Section 12(j) of the Securities Exchange Act of 1934 ("Exchange Act") against Respondent Easylink Information Technology Co., Ltd.

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. Easylink Information Technology Co., Ltd. (CIK No. 1158687) is a dissolved British Virgin Islands corporation located in Hsin Chu, Taiwan with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). Easylink Information Technology Co., Ltd. is delinquent in its periodic filings with the Commission, having not filed any periodic reports since it filed a Form 8-A12G registration statement on October 30, 2001.

B. DELINQUENT PERIODIC FILINGS

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely

periodic reports, and failed to heed a delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations or, through its failure to maintain a valid address on file with the Commission as required by Commission rules, did not receive the letter.

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

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

This Order shall be served forthwith upon Respondent personally or by certified, registered, or Express Mail, or by other means 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.

Brent J. Fields
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. 76752 / December 23, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17027**

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| **In the Matter of**<br><br>**KEVIN I. ZINN,**<br><br>**Respondent.** | **ORDER INSTITUTING ADMINISTRATIVE PROCEEDINGS PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND NOTICE OF HEARING** |

**I.**

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

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT

1. From May 2011 to approximately March 2013, Respondent acted as an unregistered broker. Specifically, Respondent solicited investors through the phone and other means to make investments in companies that purportedly bought and sold iron ore from Mexico and processed copper and other minerals in Utah. Respondent used several companies to solicit funds from investors: Global Solutions and Acquisitions, LLC, Global Solutions and Acquisitions Management, LLC ("GSAM"), and Consolidated Copper and Metals, Inc. Respondent was the managing member of GSAM. Respondent solicited money from investors by making materially false and fraudulent representations, and by concealing and omitting material facts concerning, among other things, the profitability of the investments offered, and the misappropriation of money



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from investors for the benefit of Respondent and his sales people. Specifically, Respondent misrepresented to the investors that their respective funds would be invested in an investment opportunity for a short period of time and would generate profits ranging from 5% to 15%. Furthermore, Respondent misappropriated funds and spent investor money on personal expenses. Respondent hired sales people, gave them leads of people to call and written sales pitches, and paid them for their solicitation efforts. Respondent, 46 years old, is currently incarcerated at the Adams County Correctional Institution in Natchez, Mississippi.

B. ENTRY OF THE RESPONDENT'S CRIMINAL CONVICTION

2. On October 29, 2014, Zinn entered a guilty plea in the United States District Court for the Southern District of Florida to one count of conspiracy to commit mail and wire fraud in violation of Title 18 of the United States Code, Section 1349 in connection with his involvement in an investment scheme that raised approximately $1.1 million from at least 51 individuals. U.S. v. Kevin I. Zinn, Case No. 0:14CR60213-Cohn-1 (S.D. Fla. Sep. 4, 2014).

3. Count I of the Indictment to which Zinn pled guilty alleged, inter alia, that Zinn, knowingly, and with an intent to defraud, devised and intended to devise, a scheme and artifice to defraud and to obtain money and property by means of materially false and fraudulent pretenses, representations and promises, knowing that they were false and fraudulent when made, and for the purpose of executing such scheme and artifice, knowingly caused to be delivered certain mail matter by the United States Postal Service and any private and commercial interstate carrier, including investors' checks, and certain wire communications in interstate commerce.

4. On January 8, 2015, the United States District Court for the Southern District of Florida entered a personal forfeiture money judgment in the amount of $1,114,939.00 against Respondent. On January 9, 2015, the Court sentenced Respondent to 63 months in prison and 3 years of supervised release. Respondent also was ordered to pay restitution in the amount of $920,978.38.

**III.**

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

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

B. What, if any, remedial action is appropriate in the public interest against Respondent pursuant to Section 15(b) of the Exchange Act.

## IV.

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

IT IS FURTHER ORDERED that Respondent shall file an Answer to the allegations contained in this Order within twenty (20) days after service of this Order, as provided by Rule 220 of the Commission's Rules of Practice, 17 C.F.R. § 201.220.

If Respondent fails to file the directed answer, or fails to appear at a hearing after being duly notified, the Respondent may be deemed in default and the proceedings may be determined against him upon consideration of this Order, the allegations of which may be deemed to be true as provided by Rules 155(a), 220(f), 221(f) and 310 of the Commission's Rules of Practice, 17 C.F.R. §§ 201.155(a), 201.220(f), 201.221(f) and 201.310.

This Order shall be served forthwith upon Respondent as provided for in the Commission's Rules of Practice.

IT IS FURTHER ORDERED that the Administrative Law Judge shall issue an initial decision no later than 210 days from the date of service of this Order, pursuant to Rule 360(a)(2) of the Commission's Rules of Practice.

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

By the Commission.

Brent J. Fields
Secretary

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

**SECURITIES AND EXCHANGE COMMISSION**
**Release No. 34-76766**

**December 24, 2015**

**Order Granting Temporary, Limited, and Conditional Exemption of Morningstar Credit Ratings, LLC from the Conflict of Interest Prohibition in Rule 17g-5(c)(1) of the Securities Exchange Act of 1934**

## I. Introduction

Rule 17g-5(c)(1) of the Securities Exchange Act of 1934 ("Exchange Act") prohibits a nationally recognized statistical rating organization ("NRSRO") from issuing or maintaining a credit rating solicited by a person that, in the most recently ended fiscal year, provided the NRSRO with net revenue equaling or exceeding 10% of the total net revenue of the NRSRO for the fiscal year. In adopting this rule, the Securities and Exchange Commission ("Commission") stated that a person soliciting a credit rating who was the source of 10% or more of the total net revenue of the NRSRO would be in a position to exercise substantial influence on the NRSRO, which in turn would make it difficult for the NRSRO to remain impartial given the impact on the NRSRO's income if the person withdrew its business.[1] Section 36 of the Exchange Act authorizes the Commission to exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of the Exchange Act or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

## II. Exemption Request of Morningstar Credit Ratings, LLC

Morningstar Credit Ratings, LLC ("Morningstar"), formerly known as Realpoint LLC ("Realpoint"), is a credit rating agency registered with the Commission as an NRSRO under section 15E of the Exchange Act for the class of credit ratings described in clause (iv) of section

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[1] Release No. 34-55857 (June 5, 2007), 72 FR 33564, 33598 (June 18, 2007).

3(a)(62)(A) of the Exchange Act. The Commission has previously granted Morningstar two temporary exemptions from Rule 17g-5(c)(1): (1) until January 1, 2013, allowing Morningstar to expand in the market for rating structured finance products on an issuer-paid basis ("First Morningstar Order");[2] and (2) until January 1, 2015, to allow Morningstar to continue to diversify its business beyond commercial mortgage-backed securities ("CMBS") ratings ("Second Morningstar Order").[3] The Commission also previously granted a temporary exemption from Rule 17g-5(c)(1) to Realpoint in connection with its initial registration as an NRSRO ("Realpoint Order" and, collectively with the First Morningstar Order and Second Morningstar Order, "Previous Exemptive Orders").[4]

Morningstar has informed the Commission that while it has expanded its credit ratings activity to new asset classes in addition to CMBS, it needs more time to further diversify its business and accomplish its goal to lower its revenue concentration below the 10% threshold. Accordingly, Morningstar has requested a two-year extension of its exemption from Rule 17g-5(c)(1) to enable the continued growth of its business and, thereby, foster competition in the credit rating industry.

## III. Discussion

The Commission, when adopting Rule 17g-5(c)(1), noted that it intended to monitor how the prohibition operates in practice, particularly with respect to asset-backed securities, and whether exemptions may be appropriate.[5] The Commission noted several factors in granting the Previous Exemptive Orders, including that the exemptions would further the primary purpose of

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2 Release No. 34-66514 (Mar. 5, 2012), 77 FR 14580 (Mar. 12, 2012).

3 Release No. 34-71219 (Dec. 31, 2013).

4 Release No. 34-58001 (June 23, 2008), 73 FR 36362 (June 26, 2008).

5 Release No. 34-55857, 72 FR 33598.

the Credit Rating Agency Reform Act of 2006 ("Rating Agency Act") to "improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating agency industry."[6] Citing the same factors, the Commission has issued similar orders granting temporary exemptions from the requirements of Rule 17g-5(c)(1) to LACE Financial Corp. ("LACE"), in connection with its registration as an NRSRO,[7] and to Kroll Bond Rating Agency, Inc., the successor to LACE.[8]

Morningstar has informed Commission staff that in the current fiscal year, Morningstar may receive more than 10% of its total net revenue from one or more clients that paid it to rate asset-backed securities. In the request that is subject to this Order, Morningstar states that it seeks to further diversify its credit ratings business and that a temporary extension of the exemption from Rule 17g-5(c)(1) would provide it the time needed to sufficiently lower its revenue concentration.

The Commission believes that a temporary, limited, and conditional exemption allowing Morningstar to continue to diversify its business beyond CMBS ratings is consistent with the Commission's goal, as established by the Rating Agency Act, of improving ratings quality by fostering accountability, transparency, and competition in the credit rating agency industry and is necessary or appropriate in the public interest and consistent with the protection of investors. In order to maintain this exemption, Morningstar will be required to comply with the following conditions: (1) Morningstar shall review, update, maintain, comply with, and document policies, procedures, and internal controls specifically designed to address the conflict of interest created

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6 Report of the Senate Committee on Banking, Housing, and Urban Affairs to Accompany S. 3850, Rating Agency Act, S. Report No. 109-326, 109th Cong., 2d Sess. (Sept. 6, 2006).

7 Release No. 34-57301 (Feb. 11, 2008), 73 FR 8720 (Feb. 14, 2008).

8 Release No. 34-65339 (Sept. 14, 2011), 76 FR 58319 (Sept. 20, 2011); Release No. 34-71220 (Dec. 31, 2013); Release No. 34-76129 (Oct. 13, 2015).

by exceeding the 10% threshold, including that Morningstar's Designated Compliance Officer ("DCO") shall: (a) conduct and document, on at least a quarterly basis, a review of a sample of rating files from its 2015, 2016, and 2017 fiscal years for credit ratings solicited by the applicable client or clients that provided Morningstar with 10% or more of its total net revenue, and take other steps acceptable to the Commission's examination staff, to verify that ratings of any such clients were not influenced by commercial concerns and that Morningstar adhered to such policies, procedures, and internal controls; and (b) deliver quarterly written reports about these efforts to Morningstar's President and Nominating and Corporate Governance Committee; (2) within 5 business days after the end of each quarter beginning with the last quarter of its 2015 fiscal year and through the end of its 2017 fiscal year, Morningstar's President shall file with the Commission a certification that all credit ratings issued through the end of each such quarter on deals for any client or clients that provided Morningstar with 10% or more of its total net revenue sufficiently adhered to its policies, procedures, and internal controls to address the conflict of interest created by exceeding the 10% threshold, that the DCO took appropriate measures, including rating file reviews, to confirm this adherence, and that identifies the credit ratings issued for any such clients during such quarter; (3) Morningstar shall appropriately address the Commission staff's findings and recommendations in the 2015 annual section 15E(p)(3) examination and any other examinations conducted by Commission staff during 2015, 2016, or 2017; (4) net revenue received by Morningstar from a single client may not exceed 13% of Morningstar's total net revenue for the fiscal year ending December 31, 2015, and net revenue received by Morningstar from a single client may not exceed 12% of Morningstar's total net revenue for the fiscal year ending December 31, 2016; (5) Morningstar shall publicly disclose, as applicable, in Exhibit 6 to Form NRSRO that it received 10% or more of its total net revenue in fiscal years 2015 and 2016 from a client or clients; and (6) Morningstar shall retain documentation demonstrating compliance with the conditions of the exemption.

Section 15E(p)(3) of the Exchange Act, as added by section 932(a)(8) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, requires the Commission's Office of Credit Ratings ("OCR") to conduct an examination of each NRSRO at least annually. As an integrated part of the applicable annual examinations, OCR staff will examine Morningstar's satisfaction of the conditions to this Order set forth in section IV below. If the conditions are not being fulfilled to the staff's satisfaction, the staff will consider whether to recommend that the Commission take additional action, administrative or otherwise.

## IV. Conclusion

Accordingly, pursuant to section 36 of the Exchange Act,

IT IS HEREBY ORDERED that Morningstar is exempt from the conflict of interest prohibition in Exchange Act Rule 17g-5(c)(1) until January 1, 2017 with respect to any revenue derived from issuer-paid credit ratings, provided that: (1) Morningstar shall review, update, maintain, comply with, and document policies, procedures, and internal controls specifically designed to address the conflict of interest created by exceeding the 10% threshold, including that Morningstar's DCO shall: (a) conduct and document, on at least a quarterly basis, a review of a sample of rating files from its 2015, 2016, and 2017 fiscal years for credit ratings solicited by the applicable client or clients that provided Morningstar with 10% or more of its total net revenue, and take other steps acceptable to the Commission's examination staff, to verify that ratings of any such clients were not influenced by commercial concerns and that Morningstar adhered to such policies, procedures, and internal controls; and (b) deliver quarterly written reports about these efforts to Morningstar's President and Nominating and Corporate

Governance Committee; (2) within 5 business days after the end of each quarter beginning with the last quarter of its 2015 fiscal year and through the end of its 2017 fiscal year, Morningstar's President shall file with the Commission a certification that all credit ratings issued through the end of each such quarter on deals for any client or clients that provided Morningstar with 10% or more of its total net revenue sufficiently adhered to its policies, procedures, and internal controls to address the conflict of interest created by exceeding the 10% threshold, that the DCO took appropriate measures, including rating file reviews, to confirm this adherence, and that identifies the credit ratings issued for any such clients during such quarter; (3) Morningstar shall appropriately address the Commission staff's findings and recommendations in the 2015 annual section 15E(p)(3) examination and any other examinations conducted by Commission staff during 2015, 2016, or 2017; (4) net revenue received by Morningstar from a single client shall not exceed 13% of Morningstar's total net revenue for the fiscal year ending December 31, 2015, and net revenue received by Morningstar from a single client shall not exceed 12% of Morningstar's total net revenue for the fiscal year ending December 31, 2016; (5) Morningstar shall publicly disclose, as applicable, in Exhibit 6 to Form NRSRO that it received 10% or more of its total net revenue in fiscal years 2015 and 2016 from a client or clients; and (6) Morningstar shall retain documentation demonstrating compliance with the conditions of the exemption.

By the Commission.

Brent Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**December 29, 2015**

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| **In the Matter of**<br><br>**Changda International Holdings, Inc.,**<br><br>**File No. 500-1** | **ORDER OF SUSPENSION OF TRADING** |

It appears to the Securities and Exchange Commission ("Commission") that there is a lack of current and accurate information concerning the securities of Changda International Holdings, Inc. ("CIHD[1]") (CIK No. 1417624), a revoked Nevada corporation whose principal place of business is listed as Weifang, Shandong, China because it 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, 2012. On April 28, 2015, the Commission's Division of Corporation Finance sent a delinquency letter to CIHD at the address shown in its then-most recent filing in the Commission's EDGAR system requesting compliance with its periodic filing requirements, . To date, CIHD has failed to cure its delinquencies. As of December 15, 2015, the common stock of CIHD was quoted on OTC Link operated by OTC Markets Group, Inc. (formerly "Pink Sheets") had seven market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

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

securities of the above-listed company is suspended for the period from 9:30 a.m. EST on December 29, 2015, through 11:59 p.m. EST on January 12, 2016.

By the Commission.

Brent J. Fields
Secretary

Jill M. Peterson

By: Jill M. Peterson
Assistant Secretary

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

December 29, 2015

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|---|---|
| **In the Matter of**<br><br>**Zhong Wen International Holding Co., Ltd.,**<br><br>**File No. 500-1** | **ORDER OF SUSPENSION OF TRADING** |

It appears to the Securities and Exchange Commission ("Commission") that there is a lack of current and accurate information concerning the securities of Zhong Wen International Holding Co., Ltd. ("ZWIH[1]") (CIK No. 1494502), a void Delaware corporation whose principal place of business is listed as Qingzhou, Shandong, China because it 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, 2012. On February 19, 2015, the Commission's Division of Corporation Finance sent a delinquency letter to ZWIH at the address shown in its then-most recent filing in the Commission's EDGAR system requesting compliance with its periodic filing requirements. To date, ZWIH has failed to cure its delinquencies. As of December 15, 2015, the common stock of ZWIH was quoted on OTC Link operated by OTC Markets Group, Inc. (formerly "Pink Sheets") had three market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

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

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 December 29, 2015, through 11:59 p.m. EST on January 12, 2016.

By the Commission.

Brent J. Fields
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. 76783 / December 29, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17028**

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| **In the Matter of**<br><br>**Zhong Wen International Holding Co., Ltd.,**<br><br>**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 the respondent named in the caption.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT [1]

1. Zhong Wen International Holding Co., Ltd. ("ZWIH") (CIK No. 1494502) is a void Delaware corporation located in Qingzhou, Shandong, China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). ZWIH 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, 2012. As of December 15, 2015, the common stock of ZWIH was quoted on OTC Link operated by OTC Markets Group, Inc. (formerly "Pink Sheets") had three market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely periodic

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

reports and failed to bring its filings current in response to the delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations.

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

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

## III.

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

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or 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 the Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, 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 the Respondent 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.

Brent J. Fields
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. 76785 / December 29, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17029**

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| **In the Matter of**<br><br>**Changda International Holdings, Inc.,**<br><br>**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 the respondent named in the caption.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT [1]

1. Changda International Holdings, Inc. ("CIHD") (CIK No. 1417624) is a revoked Nevada corporation located in Weifang, Shandong, China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CIHD 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, 2012. As of December 15, 2015, the common stock of CIHD was quoted on OTC Link operated by OTC Markets Group, Inc. (formerly "Pink Sheets") had seven market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely periodic

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

reports and failed to bring its filings current in response to the delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations.

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

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

**III.**

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

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or 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 the Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, 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 the Respondent 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.

Brent J. Fields
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. 76791 / December 30, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17030**

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| **In the Matter of**<br><br>**USA Graphite, Inc.,**<br><br>**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 the Respondent named in the caption.

## II.

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT [1]

1. USA Graphite, Inc. ("USGT") (CIK No. 1355420) is a revoked Nevada corporation located in Kuala Lumpur, Malaysia with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). USGT 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 August 31, 2013, which reported a net loss of $50,613 for the prior six months. As of October 30, 2015, the common stock of USGT was quoted on OTC Link operated by OTC Markets Group, Inc. (formerly "Pink Sheets") had eleven market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

B. DELINQUENT PERIODIC FILINGS

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely periodic

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

reports and failed to bring its filings current in response to the delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations.

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

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

## III.

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

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or 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 the Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, 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 the Respondent 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.

Brent J. Fields
Secretary

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

**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**December 30, 2015**

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|---|---|
| **In the Matter of**<br><br>**USA Graphite, Inc.,**<br><br>**File No. 500-1** | **ORDER OF SUSPENSION OF TRADING** |

It appears to the Securities and Exchange Commission ("Commission") that there is a lack of current and accurate information concerning the securities of USA Graphite, Inc. ("USGT[1]") (CIK No. 1355420), a revoked Nevada corporation whose principal place of business is listed as Kuala Lumpur, Malaysia because it 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 August 31, 2013. On April 22, 2015, the Commission's Division of Corporation Finance sent a delinquency letter to USGT at the address shown in its then-most recent filing in the Commission's EDGAR system requesting compliance with its periodic filing requirements, which USGT received on April 25, 2015. To date, USGT has failed to cure its delinquencies. As of December 15, 2015, the common stock of USGT was quoted on OTC Link operated by OTC Markets Group, Inc. (formerly "Pink Sheets") had seven market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

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

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 December 30, 2015, through 11:59 p.m. EST on January 13, 2016.

By the Commission.

Brent J. Fields
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. 76793 / December 30, 2015**

**ADMINISTRATIVE PROCEEDING**
**File No. 3-17031**

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| **In the Matter of**<br><br>**China Domestica Bio-technology Holdings, Inc.,**<br><br>**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 the Respondent named in the caption.

**II.**

After an investigation, the Division of Enforcement alleges that:

A. RESPONDENT [1]

1. China Domestica Bio-technology Holdings, Inc. ("CDBH") (CIK No. 1380706) is a defaulted Nevada corporation located in LungFung District, Shenzhen, China with a class of securities registered with the Commission pursuant to Exchange Act Section 12(g). CDBH 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, 2012, which reported a net loss of $35,913 for the prior year. As of December 15, 2015, the common stock of CDBH was quoted on OTC Link operated by OTC Markets Group, Inc. (formerly "Pink Sheets") had three market makers and was eligible for the "piggyback" exception of Exchange Act Rule 15c2-11(f)(3).

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

B. DELINQUENT PERIODIC FILINGS

2. As discussed in more detail above, the Respondent is delinquent in its periodic filings with the Commission, has repeatedly failed to meet its obligations to file timely periodic reports and failed to bring its filings current in response to the delinquency letter sent to it by the Division of Corporation Finance requesting compliance with its periodic filing obligations.

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

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

## III.

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

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

B. Whether it is necessary and appropriate for the protection of investors to suspend for a period not exceeding twelve months, or 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 the Respondent shall file an Answer to the allegations contained in this Order within ten (10) days after service of this Order, as provided by Rule 220(b) of the Commission's Rules of Practice [17 C.F.R. § 201.220(b)].

If the Respondent fails to file the directed Answer, or fails to appear at a hearing after being duly notified, the Respondent, 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 the Respondent 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.

Brent J. Fields
Secretary

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

**UNITED STATES OF AMERICA**
**Before the**
**SECURITIES AND EXCHANGE COMMISSION**

**December 30, 2015**

| | |
|---|---|
| **In the Matter of**<br><br>**China Domestica Bio-technology Holdings, Inc.,**<br><br>**File No. 500-1** | **ORDER OF SUSPENSION OF TRADING** |

It appears to the Securities and Exchange Commission ("Commission") that there is a lack of current and accurate information concerning the securities of Changda International Holdings, Inc. ("CDBH[1]") (CIK No. 1380706), a defaulted Nevada corporation whose principal place of business is listed as LungFung District, Shenzhen, China because it 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, 2012. As of December 15, CDBH's common stock was quoted on OTC Link (previously "Pink Sheets") operated by OTC Markets Group Inc. On April 28, 2015, the Commission's Division of Corporation Finance sent a delinquency letter to CDBH at the address shown in its then-most recent filing in the Commission's EDGAR system requesting compliance with its periodic filing requirements. To date, CDBH has failed to cure its delinquencies.

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

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

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 December 30, 2015, through 11:59 p.m. EST on January 13, 2016.

By the Commission.

Brent J. Fields
Secretary

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