

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposal is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of Nasdaq. All submissions should refer to file number SR-NASD-2001-08 and should be submitted by December 4, 2001.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority,<sup>15</sup>

**Margaret H. McFarland,**  
Deputy Secretary.

[FR Doc. 01-28273 Filed 11-9-01; 8:45 am]

BILLING CODE 8010-01-M

#### SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45024; File No. SR-NASD-2001-79]

#### Self-Regulatory Organizations; Notice of Filing and Order Granting Accelerated Approval of a Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Enhanced Return Notes Linked to the Nasdaq 100-Index

November 5, 2001.

Pursuant to section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 31, 2001, the National Association of Securities Dealers, Inc. ("NASD" or "Association") through its subsidiary, The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("Commission" or "SEC") the proposed

efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

<sup>15</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

rule change as described in Items I and II below, which Items have been prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons and to approve the proposal on an accelerated basis.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

Nasdaq proposes to list and trade Enhanced Return Notes Linked to the Nasdaq-100 Index (the "Notes") issued by Merrill Lynch & Co., Inc. ("Merrill Lynch").

#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, Nasdaq included statements concerning the purpose of, and basis for, the proposed rule change, and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item III below. Nasdaq has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

#### A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

##### (1) Purpose

Under NASD Rule 4420(f), "Other Securities," Nasdaq may approve for listing and trading innovative securities that cannot be categorized readily under traditional listing guidelines.<sup>3</sup> Nasdaq proposes to list for trading the Notes, as described below, under NASD Rule 4420(f).

##### Description of the Notes

The Notes<sup>4</sup> are a series of senior debt securities that will be issued by Merrill Lynch and will not be secured by collateral. The Notes will be issued in denominations of whole units ("Units"), with each Unit representing a single Note. The original public offering price will be \$10 per Unit. The Notes will not pay interest and are not subject to redemption by Merrill Lynch or at the

<sup>3</sup> See Securities Exchange Act Release No. 32988 (September 29, 1993), 58 FR 52124 (October 6, 1993) (order approving File No. SR-NASD-93-15) ("1993 Order").

<sup>4</sup> For a detailed description of the Notes, including the risks associated with investing in the Notes, see the registration statement Merrill Lynch filed with the Commission (File No. 333-52822).

option of any beneficial owner before maturity in February 2003.<sup>5</sup>

At maturity, if the value of the Nasdaq-100 Index ("Index")<sup>6</sup> has increased, a beneficial owner will be entitled to receive a payment on the Notes based on twice the amount of that percentage increase, not to exceed a maximum payment of \$14.00 per Unit (the "Capped Value").<sup>7</sup> Thus, the Notes provide investors with an opportunity to obtain leveraged returns based on the Index. Unlike ordinary debt securities, the Notes do not guarantee any return of principal at maturity. Therefore, if the value of the Index has declined at maturity, a beneficial owner will receive less, and possibly significantly less, than the original public offering price of \$10 per Unit.

The payment that a beneficial owner will be entitled to receive (the "Redemption Amount") depends entirely on the relation of the average of the values of the Index at the close of the market on five business days shortly before the maturity of the Notes (the "Ending Value") and the closing value of the Index on the date the Notes are priced for initial sale to the public (the "Starting Value").

<sup>5</sup> The maturity date will be determined on the day the Notes are priced. After Nasdaq filed its proposal, Merrill Lynch revised the terms of the Notes to establish a maturity date of February 2003, rather than January 2003, and to provide for a maximum payment on the Notes of \$14.00 per Unit. Telephone conversation between John Nachmann, Senior Attorney, Nasdaq, and Yvonne Fraticelli, Special Counsel, Office of Market Supervision, Division of Market Regulation, Commission, on November 5, 2001.

<sup>6</sup> The Index is a modified capitalization-weighted index of 100 of the largest non-financial companies listed on The Nasdaq National Market tier of Nasdaq. The Index constitutes a broadly diversified segment of the largest and most actively traded securities listed on Nasdaq and includes companies across a variety of major industry groups. To limit domination of the Index by a few large stocks, the Index is calculated under a "modified capitalization-weighted" methodology. This capitalization weight distribution is evaluated on a quarterly basis and is rebalanced if either one or both of the following two weight distribution requirements are not met: (1) The current weight of the single largest market capitalization security must be less than or equal to 24.0%, and (2) the "collective weight" of those Index component securities whose individual current weights are in excess of 4.5%, when added together, must be less than or equal to 48.0%. Index securities are ranked by market value and are evaluated annually to determine which securities will be included in the Index. Moreover, if at any time during the year an Index security is no longer trading on Nasdaq, or is otherwise determined by Nasdaq to become ineligible for continued inclusion in the Index, the security will be replaced with the largest market capitalization security not currently in the Index that meets the Index eligibility criteria. For a detailed description of the Index, see the registration statement filed by Merrill Lynch with the Commission (File No. 333-52822).

<sup>7</sup> The final Capped Value will be determined on the day the Notes are priced.

If the Ending Value is less than or equal to the Starting Value, the

Redemption Amount per Unit will equal:

If the Ending Value is greater than the Starting Value, the Redemption Amount per Unit will equal:

$$\$10 \times \left( \frac{\text{Ending Value}}{\text{Starting Value}} \right)$$

$$\$10 + \left( \$10 \times \left( 2 \times \left( \frac{\text{Ending Value} - \text{Starting Value}}{\text{Starting Value}} \right) \right) \right)$$

not to exceed the Capped Value of \$14.00 per Unit.

#### *Criteria for Initial and Continued Listing*

The Notes will be subject to Nasdaq's initial listing criteria for other securities under NASD Rule 4420(f). Specifically, under NASD Rule 4420(f)(1):

(A) The issuer shall have assets in excess of \$100 million and stockholders' equity of at least \$10 million. In the case of an issuer which is unable to satisfy the income criteria set forth in paragraph (a)(1), Nasdaq generally will require the issuer to have the following: (i) Assets in excess of \$200 million and stockholders' equity of at least \$10 million; or (ii) assets in excess of \$100 million and stockholders' equity of at least \$20 million;

(B) There must be a minimum of 400 holders of the security, provided, however, that if the instrument is traded in \$1,000 denominations, there must be a minimum of 100 holders.

(C) For equity securities designated pursuant to this paragraph, there must be a minimum public distribution of 1,000,000 trading units;

(D) The aggregate market value/principal amount of the security will be at least \$4 million.

In addition, Nasdaq notes that Merrill Lynch satisfies the listed marketplace requirement set forth in NASD Rule 4420(f)(2).<sup>8</sup> Lastly, pursuant to NASD Rule 4420(f)(3), prior to the commencement of trading of the Notes, Nasdaq will distribute a circular to the membership providing guidance regarding member firm compliance responsibilities and requirements, including suitability recommendations, and highlighting the special risks and characteristics of the Notes. In particular, Nasdaq will advise members, member organizations and employees thereof recommending a transaction in the Notes to: (1) Determine that such transaction is suitable for the customer;

and (2) have a reasonable basis for believing that the customer can evaluate the special characteristics of, and is able to bear the financial risks of, such transaction.

The Notes will be subject to Nasdaq's continued listing criteria for other securities in NASD Rule 4450(c), which requires that the aggregate market value or principal amount of publicly-held units must be at least \$1 million. Furthermore, the Notes must have at least two registered and active market makers as required by NASD Rule 4450(e).

The Notes will be registered under section 12 of the Act.

#### *Rules Applicable To the Trading of the Notes*

Because the Notes will be deemed equity securities for the purpose of NASD Rule 4420(f), the NASD and Nasdaq's existing equity trading rules will apply to the Notes. First, pursuant to NASD Rule 2310, "Recommendations to Customers (Suitability)," and IM-2310-2, "Fair Dealing with Customers," NASD members must have reasonable grounds for believing that a recommendation to a customer regarding the purchase, sale or exchange of any security is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.<sup>9</sup> In addition, as previously mentioned, Nasdaq will distribute a circular to advise members, member organizations and employees thereof recommending a transaction in the Notes to, among other things, have a reasonable basis for believing that the customer can evaluate the special characteristics of, and is able to bear the financial risks of, such transaction. Second, the Notes will be subject to the equity margin rules.

<sup>9</sup> NASD Rule 2310(b) requires members to make reasonable efforts to obtain information concerning a customer's financial status, a customer's tax status, a customer's investment objectives, and such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

Third, the regular equity trading hours of 9:30 a.m. to 4 p.m. will apply to transactions in the Notes. Lastly, NASD Regulation's surveillance procedures for the Notes will be the same as the current surveillance procedures governing equity securities, and will include additional monitoring on key pricing dates.

#### *Disclosure and Dissemination of Information*

Merrill Lynch will deliver a prospectus in connection with the initial purchase of the Notes. The procedure for the delivery of a prospectus will be the same as Merrill Lynch's current procedure involving primary offerings. In addition, Nasdaq will issue a circular to NASD members explaining the unique characteristics and risks of the Notes.

#### (2) Basis

Nasdaq believes that the proposed rule change is consistent with section 15A of the Act, in general, and furthers the objectives of section 15A(b)(6), in particular, in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and, in general, to protect investors and the public interest.

#### *B. Self-Regulatory Organization's Statement on Burden on Competition*

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

#### *C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others*

Written comments were neither solicited nor received.

### III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing,

<sup>8</sup> NASD Rule 4420(f)(2) generally requires that issuers of securities designated pursuant to NASD Rule 4420(e) be listed on Nasdaq or the New York Stock Exchange, Inc. ("NYSE") or be an affiliate of a company listed on Nasdaq or the NYSE.

including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to file number SR-NASD-2001-79 and should be submitted by December 4, 2001.

#### IV. Commission Findings and Order Granting Accelerated Approval of the Proposed Rule Change

Nasdaq has asked the Commission to approve the proposal on an accelerated basis to accommodate the timetable for listing the Notes.

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities association and, in particular, with the requirements of section 15A(b)(6) of the Act<sup>10</sup> in that it is designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market, and, in general, to protect investors and the public interest.<sup>11</sup> The Commission believes that the Notes will provide investors with a means to participate in any percentage increase in the Index that exists at the maturity of the Notes, subject to the Capped Value. Specifically, as described more fully above, a beneficial owner will be entitled to receive at maturity a payment on the Notes based on twice the amount of any percentage increase in the Index, not to exceed the Capped Value.

The Notes are leveraged debt instruments whose price will be derived from and based upon the value of the Index. In addition, as discussed more fully above, the Notes do not guarantee any return of principal at maturity.

Thus, if the Index has declined at maturity, a beneficial owner may receive significantly less than the original public offering price of the Notes. Accordingly, the level of risk involved in the purchase or sale of the Notes is similar to the risk involved in the purchase or sale of traditional common stock. Because the final rate of return on the Notes is derivatively priced and based upon the performance of an index of securities, because the Notes are debt instruments that do not guarantee a return of principal, and because investors' potential return is limited by the Capped Value, there are several issues regarding trading of this type of product. For the reasons discussed below, the Commission believes that Nasdaq's proposal adequately addresses the concerns raised by this type of product.

First, the Commission notes that the protections of NASD Rule 4420(f) were designed to address the concerns attendant to the trading of hybrid securities like the Notes.<sup>12</sup> In particular, by imposing the hybrid listing standards, heightened suitability for recommendations,<sup>13</sup> and compliance requirements, noted above, the Commission believes that Nasdaq has adequately addressed the potential problems that could arise from the hybrid nature of the Notes. The Commission notes that Nasdaq will distribute a circular to its membership that provides guidance regarding member firm compliance responsibilities and requirements, including suitability recommendations, and highlights the special risks and characteristics associated with the Notes. Specifically, among other things, the circular will indicate that the Notes do not guarantee any return of principal at maturity, that the maximum return on the Notes is limited to \$14.00 per unit, that the Notes will not pay interest, and that the Notes will provide full exposure to any downside movement in the Index. Distribution of the circular should help to ensure that only customers with an understanding of the risks attendant to the trading of the Notes and who are able to bear the financial risks associated with transactions in the Notes will trade the Notes. In addition, the Commission notes that Merrill Lynch will deliver a

prospectus in connection with the initial purchase of the Notes.

Second, the Commission notes that the final rate of return on the Notes depends, in part, upon the individual credit of the issuer, Merrill Lynch. To some extent this credit risk is minimized by the NASD's listing standards in NASD Rule 4420(f), which provide that only issuers satisfying substantial asset and equity requirements may issue these types of hybrid securities. In addition, the NASD's hybrid listing standards further require that the Notes have at least \$4 million in market value. Financial information regarding Merrill Lynch, in addition to information concerning the issuers of the securities comprising the Index, will be publicly available.<sup>14</sup>

Third, the Notes will be registered under section 12 of the Act. As noted above, the NASD's and Nasdaq's existing equity trading rules will apply to the Notes, which will be subject to equity margin rules and will trade during the regular equity trading hours of 9:30 a.m. to 4 p.m. NASD Regulation's surveillance procedures for the Notes will be the same as its current surveillance procedures for equity securities, and will include additional monitoring on key pricing dates.

Fourth, the Commission has a systemic concern that a broker-dealer, such as Merrill Lynch, or a subsidiary providing a hedge for the issuer will incur position exposure. However, as the Commission has concluded in previous approval orders for other hybrid instruments issued by broker-dealers,<sup>15</sup> the Commission believes that this concern is minimal given the size of the Notes issuance in relation to the net worth of Merrill Lynch.

Finally, the Commission believes that the listing and trading of the proposed Notes should not unduly impact the market for the securities underlying the Index or raise manipulative concerns. The Commission notes that the Index is

<sup>14</sup> The companies comprising the Index are reporting companies under the Act.

<sup>15</sup> See, e.g., Securities Exchange Act Release Nos. 44913 (October 9, 2001), 66 FR 52469 (October 15, 2001) (order approving File No. SR-NASD-2001-73) (approving the listing and trading of notes issued by Morgan Stanley Dean Witter & Co. whose return is based on the performance of the Index); 44483 (June 27, 2001), 66 FR 35677 (July 6, 2001) (order approving File No. SR-Amex-2001-40) (approving the listing and trading of notes issued by Merrill Lynch whose return is based on a portfolio of 20 securities selected from the Amex Institutional Index); and 37744 (September 27, 1996), 61 FR 52480 (October 7, 1996) (order approving File No. SR-Amex-96-27) (approving the listing and trading of notes issued by Merrill Lynch whose return is based on a weighted portfolio of healthcare/biotechnology industry securities).

<sup>12</sup> See 1993 Order, *supra* note 3.

<sup>13</sup> As discussed above, Nasdaq will advise members, member organizations, and employees thereof recommending a transaction in the Notes to: (1) Determine that the transaction is suitable for the customer; and (2) have a reasonable basis for believing that the customer can evaluate the special characteristics of, and is able to bear the financial risks of, the transaction.

<sup>10</sup> 15 U.S.C. 78o-3(b)(6).

<sup>11</sup> In approving the proposed rule, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

well-established and broad-based. In addition, the Commission continues to believe, as it has concluded previously, that the large capitalizations, liquid markets, and relative weightings of the Index's component stocks significantly minimize the potential for manipulation of the Index.<sup>16</sup> The Commission also believes that the weighting methodology for the Index should ensure that no one stock or groups of stocks dominates the Index, and reduces the potential influence of any one stock on the movement of the Index.<sup>17</sup> In addition, Nasdaq's surveillance procedures should serve to deter as well as detect any potential manipulation.

The Commission finds good cause for approving the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof in the **Federal Register**. The Commission believes that the Notes will provide investors with an additional investment choice and that accelerated approval of the proposal will allow investors to begin trading the Notes promptly. Accordingly, the Commission believes that there is good cause, consistent with sections 15A(b)(6) and 19(b)(2) of the Act,<sup>18</sup> to approve the proposal on an accelerated basis.

The Commission is approving Nasdaq's proposed listing standards for the Notes. The Commission specifically notes that, notwithstanding approval of the listing standards for the Notes, other similarly structured products will require review by the Commission prior to being traded on Nasdaq.

*It is therefore ordered*, pursuant to section 19(b)(2) of the Act, that the proposed rule change (SR-NASD-2001-79) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>19</sup>

**Margaret H. McFarland,**  
*Deputy Secretary.*

[FR Doc. 01-28275 Filed 11-9-01; 8:45 am]

**BILLING CODE 8010-01-M**

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-45016; File No. SR-NASD-2001-66]

### Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change, Amendment No. 1, and Amendment No. 2 Thereto by the National Association of Securities Dealers, Inc. Relating To Display Requirements When Using Reserve Size in the Nasdaq National Market Execution System

November 5, 2001.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on October 4, 2001, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its subsidiary The Nasdaq Stock Market, Inc. ("Nasdaq"), filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the NASD. On October 23, 2001, the NASD submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On October 29, 2001, the NASD submitted Amendment No. 2 to the proposed rule change.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The NASD proposes to amend NASD Rule 4710 to reduce the 1000 share display size requirement to 100 shares for using the reserve size functionality

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine England, Assistant Director, Division of Market Regulation ("Division"), Commission, dated October 23, 2001 ("Amendment No. 1"). In Amendment No. 1, the NASD intended to amend rule text; however, an unintentional oversight by the NASD resulted in the rule text remaining the same.

<sup>4</sup> See letter from Thomas P. Moran, Associate General Counsel, Nasdaq, to Katherine England, Assistant Director, Division, Commission, dated October 29, 2001 ("Amendment No. 2"). In Amendment No. 2, the NASD included the rule text change it unintentionally omitted in Amendment No. 1. Specifically, the NASD amended Nasdaq Rule 4710(b) to require a minimum of 100 shares displayed in a market maker's quote and that the market maker's quotation must be refreshed to 100 shares consistent with other provisions within the Rule. The NASD also changed the status of the proposed rule change from one filed pursuant to section 19(b)(3)(A) of the Act, 15 U.S.C. 78s(b)(3)(A), to one filed pursuant to section 19(b)(2) of the Act, 15 U.S.C. 78s(b)(2).

in the Nasdaq National Market Execution System ("NNMS" or "SuperSOES").

The text of the proposed rule change, as amended, appear below. New text is in italics; deletions are in brackets.

4710. Participant Obligations in NNMS

(a) No Change.

(b) Market Makers

(1) An NNMS Market Maker in an NNMS Security shall be subject to the following requirements:

(A) For each NNM security in which it is registered as an NNMS Market Maker, the market maker must execute individual orders against its quotation including its Agency Quote (if applicable), in an amount equal to or smaller than the combination of the displayed quotation and reserve size of such quotation(s). For purposes of this rule, the term "reserved size" shall mean that a NNMS Market Maker or a customer thereof wishes to display publicly part of the full size of its order or interest with the remainder held in reserve on an undisplayed basis to be displayed in whole or in part as the displayed part is executed. To utilize the reserve size function, a minimum of [1,000] 100 shares must initially be displayed in the market maker's quote (including the Agency Quote), and the quotation must be refreshed to [1,000] 100 shares consistent with subparagraph (b)(2)(A) of this rule.

(B)-(E) No Change.

(2) Refresh Functionality

(A) Reserve Size Refresh—Once an NNMS Market Maker's displayed quotation size on either side of the market in the security has been decremented to zero due to NNMS executions, Nasdaq will refresh the market maker's displayed size out of reserve size to a size-level designated by the NNMS Market Maker, or in the absence of such size-level designation, to the automatic refresh size. If the market maker is using the reserve size function for its proprietary quote or Agency Quote, the market maker must refresh to a minimum of [1,000] 100 shares, consistent with subparagraph (b)(1)(A) of this rule.

(B) No Change.

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#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change, as amended, and discussed any comments it received on the proposed rule change. The text of

<sup>16</sup> See Securities Exchange Act Release No. 33428 (January 5, 1994), 59 FR 1576 (January 11, 1994) (order approving File No. SR-CBOE-93-42) (approving the listing and trading of Index options on the Chicago Board Options Exchange).

<sup>17</sup> See Securities Exchange Act Release No. 40642 (November 5, 1998) 63 FR 63759 (November 16, 1998) (order approving File No. SR-CBOE-98-43).

<sup>18</sup> 15 U.S.C. 78o-3(b)(6) and 78s(b)(2).

<sup>19</sup> 17 CFR 200.30-3(a)(12).