Investment Services Regulatory Update

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Monthly Version

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NEW RULES

SEC Adopts New Short Sale Reporting Requirements for Institutional Investment Managers

On October 13, 2023, the SEC adopted new Rule 13f-2 under the Exchange Act and new Form SHO requiring institutional investment managers to file confidential monthly reports with the SEC regarding certain short sale data. The SEC expects to publish data derived from Form SHO reports, aggregated across all reporting managers (i.e., without identifying individual managers), within one month after the end of the reporting calendar month (e.g., short sale data reported for October would be published before the end of November). This information is intended to supplement the current short sale transaction information provided by major U.S. stock exchanges and FINRA. Key elements of the new rule and reporting requirements are summarized below.

When the Reporting Obligation is Triggered

Rule 13f-2 will require institutional investment managers to file new Form SHO with the SEC within 14 calendar days of the end of each month, with respect to short sale activity and positions for which the manager exercises investment discretion, subject to reporting thresholds that differ based on whether the subject equity security is of a reporting or non-reporting issuer (i.e., whether the issuer is required to file reports pursuant to the Exchange Act), as follows:

- For each equity security of a reporting company issuer when the manager has either (1) a monthly average gross short position at the close of regular trading hours in the equity security of $10 million or more, or (2) a monthly average gross short position at the close of regular trading hours as a percentage of shares outstanding in the equity security of 2.5% or more.
- For each equity security of a non-reporting company issuer when the manager has a gross short position in the equity security with a U.S. dollar value of $500,000 or more at the close of regular trading hours on any settlement date during the calendar month.

Thus, for equity securities issued by reporting companies, there is a two-prong threshold calculated as monthly averages, whereas, for non-reporting companies, there is a single dollar threshold that can be triggered following a single day in which the short position exceeds $500,000.

Economic short positions created through the use of swaps or other derivatives do not need to be included when calculating the reporting thresholds.

Reporting Persons

- "Institutional investment manager" includes any person, other than a natural person, investing in or buying and selling securities for its own account, and any person exercising investment discretion with respect to the account of any other person.
- Consequently, the definition of "institutional investment manager" for new Rule 13f-2 is the same that is used for purposes of current Schedule 13F reporting requirements which, notably, apply to managers that exercise investment discretion over $100 million or more in Section 13(f) securities. As practitioners know, various types of firms may unknowingly fall within the scope of Form 13F reporting obligations, even if not an SEC-registered investment adviser—i.e., including broker-dealers, banks, bank holding companies and other financial institutions and firms. Without the $100 million threshold that applies to Form 13F reporting obligations, the new short sale reporting regime captures an even broader group of "institutional investment managers." The SEC's adopting release notes that the term may include various market participants, including investment advisers, brokers and dealers, banks, insurance companies and pension funds, among others.

Information Required in Form SHO

For each reported equity security, an institutional investment manager's Form SHO must include:

- the end-of-month gross short position in the equity security at the close of regular trading hours on the last settlement date of the calendar month; and
- the "net" activity in the reported equity security, which includes activity in derivatives, for each individual settlement date during the calendar month.

Key Dates
Rule 13f-2 will become effective on January 2, 2024. The compliance date for Rule 13f-2 and Form SHO will be 12 months after the effective date.

The SEC's adopting release is available here, a related fact sheet is available here, and a related press release is available here.

SEC Adopts Securities Lending Disclosure Requirement

On October 13, 2023, the SEC adopted new Rule 10c-1a under the Securities Exchange Act of 1934, which will require the reporting of certain details regarding securities lending transactions to a registered national securities association (RNSA). Currently, FINRA is the only RNSA.

New Rule 10c-1a will require any "covered person" to provide specified information about "covered securities loans" to an RNSA within a certain time period and in accordance with the format and manner required by rules that the RNSA will adopt. The new rule will also require the RNSA to make publicly available certain information it receives about securities loans and to keep confidential certain other information it receives. Reportable information to be made public will include identifying information about the security subject to the loan and its issuer; the date and time of the loan; the name of the platform or venue where the loan is affected; the amount of securities on loan; the type of collateral used to secure the loan; rates, fees, charges and rebates for the loan; the loan's termination date; and the type of entity that is the borrower of the security (i.e., if the borrower is a broker, dealer, customer, clearing agency, bank, custodian or other person). Reportable information that the RNSA must keep confidential will include the legal names of the parties to the covered securities loan; if the lender is a broker or dealer and the borrower is its customer, whether the security on loan came from the lender's inventory; and if known, whether the loan will be used to close out a fail to deliver under Regulation SHO or to close out a fail to deliver outside of Regulation SHO. The rule will also require covered persons to report certain information to RNSAs about modifications to outstanding covered securities loans.

For purposes of the new reporting requirements, Rule 10c-1a defines a covered person as (1) any person that agrees to a covered securities loan on behalf of a lender (i.e., an intermediary), other than a clearing agency; (2) any person that agrees to a covered securities loan as the lender when an intermediary is not used; or (3) a broker or dealer when borrowing fully paid or excess margin securities. The rule defines a covered securities loan as any transaction in which one person, either on that person's own behalf or on behalf of one or more other persons, lends a "reportable security" to another person. The rule excludes from the definition of covered securities loans positions at a registered clearing agency resulting from central counterparty services or central depository services and the use of margin securities by a broker or dealer unless the broker or dealer lends the securities to another person. Finally, to identify whether a particular securities loan is a covered securities loan, Rule 10c-1a defines a reportable security as any security for which information is reported or required to be reported to the consolidated audit trail in accordance with existing reporting regimes such as the Consolidated Audit Trail National Market System Plan, FINRA's TRACE reporting system or the Municipal Securities Rulemaking Board's Real-Time Transaction Reporting System.

Rule 10c-1a will require that a covered person provide the requisite information about a covered securities loan to an RNSA by the end of the day on which the loan is made or modified, and that the RNSA assign a unique identifier to each covered securities loan and make the requisite information about the loan public no later than the morning of the next business day.

Rule 10c-1a will become effective on January 2, 2024. The adopting release for the rule specifies that (1) RNSAs must propose rules to implement Rule 10c-1a within four months of the effective date of Rule 10c-1a; (2) those RNSA rules must be effective no later than 12 months after the effective date of Rule 10c-1a; (3) covered persons must begin reporting information required by Rule 10c-1a to RNSAs starting on the first business day 24 months after the effective date of Rule 10c-1a (i.e., the reporting date); and (4) RNSAs must begin publicly reporting required information about covered securities loans within 90 calendar days of the reporting date.

The SEC's adopting release is available here, a related fact sheet is available here, and a related press release is available here.

SEC Adopts Significant Amendments to Beneficial Ownership Reporting Requirements

On October 10, 2023, the SEC adopted significant amendments to the rules governing beneficial ownership reporting, including accelerated filing deadlines for Schedules 13D and 13G filers.

The following table compares the current and new filing deadlines, including certain differences in requirements among Qualified Institutional Investors, passive investors and exempt investors, as well as amendment triggering events and deadlines for such amendment filings.

	SCHEDULE 13D	SCHEDULE 13G—QUALIFIED INSTITUTIONAL INVESTOR	SCHEDULE 13G—PASSIVE INVESTOR	SCHEDULE 13G—EXEMPT INVESTOR
Initial Filing Deadline—Current Requirement	**10 days** after acquiring more than 5% beneficial ownership or losing eligibility to file on Schedule 13G	45 days after **calendar year-end** in which beneficial ownership exceeds 5% **10 days** after month-end in which beneficial ownership exceeds 10%	**10 days** after acquiring more than 5% beneficial ownership	45 days after **calendar year-end** in which beneficial ownership exceeds 5%
Initial Filing Deadline—New Requirement	**5 business days** after acquiring more than 5% beneficial ownership or losing eligibility to file on Schedule 13G	45 days after **calendar quarter-end** in which beneficial ownership exceeds 5% **5 business days** after month-end in which beneficial ownership exceeds 10%	**5 business days** after acquiring more than 5% beneficial ownership	45 days after **calendar quarter-end** in which beneficial ownership exceeds 5%
Amendment Triggering Event—Current Requirement	Material change in the facts set forth in the previous Schedule 13D	**Any change** in information previously reported on Schedule 13G Upon exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership	**Any change** in information previously reported on Schedule 13G Upon exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership	**Any change** in information previously reported on Schedule 13G
Amendment Triggering Event—New Requirement	Material change in the facts set forth in the previous Schedule 13D (no change from current requirement)	**Material change** in information previously reported on Schedule 13G Upon exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership (no change from current requirement)	**Material change** in information previously reported on Schedule 13G Upon exceeding 10% beneficial ownership or a 5% increase or decrease in beneficial ownership (no change from current requirement)	**Material change** in information previously reported on Schedule 13G
Amendment Filing Deadline—Current Requirement	**Promptly** after triggering event	45 days after calendar year-end in which **any change** occurred **10 days** after month-end in which beneficial ownership exceeds 10%; and thereafter, within **10 days** after month-end in which beneficial ownership increased or decreased by more than 5%	45 days after calendar year-end in which **any change** occurred **Promptly** after acquiring more than 10% beneficial ownership; and thereafter, **promptly** after increasing or decreasing beneficial ownership by more than 5%	45 days after calendar year-end in which **any change** occurred
Amendment Filing Deadline—New Requirement	**2 business days** after triggering event	45 days after calendar year-end in which a **material change** occurred **5 business days** after month-end in which beneficial ownership exceeds 10%; and thereafter, within **5 business days** after month-end in which beneficial ownership increased or decreased by more than 5%	45 days after calendar year-end in which a **material change** occurred **2 business days** after acquiring more than 10% beneficial ownership; and thereafter, within **2 business days** after increasing or decreasing beneficial ownership by more than 5%	45 days after calendar year-end in which a **material change** occurred

Other Elements of the Amendments and the SEC's Adopting Release

- **Extended Filing Cut-off Times**. To accommodate the accelerated filing deadlines, cut-off times for Schedule 13D and 13G filings are extended from 5:30 p.m. to 10:00 p.m. ET.

- **Guidance on "Group" Beneficial Ownership**. Rather than adopting certain proposed amendments to Rule 13d-5(b), the SEC included guidance in the adopting release regarding the appropriate legal standard for determining whether a "group" is formed for purposes of the reporting requirements. Among other things, the SEC noted that the determination depends on an analysis of all relevant facts and circumstances and not solely on the presence or absence of an express agreement, and that the evidence must show, at a minimum, indicia, such as an informal arrangement or coordination in furtherance of, a common purpose to acquire, hold or dispose of securities of an issuer. Shareholder engagement activities involving discussions and exchanging views, without other actions, would not constitute formation of a group. Similarly, the adopting release states that when shareholders jointly make recommendations to an issuer regarding the structure and composition of the issuer's board of directors that do not involve attempts to convince the board to take specific actions through a change in the existing board membership or bind the board to take action, the SEC does not believe a group is formed.

- **Guidance on Beneficial Ownership through Cash-Settled Derivative Securities**. As with proposed amendments regarding formation of a group, the SEC, rather than adopting proposed rule amendments, included guidance in the adopting release about circumstances in which a holder of a cash-settled derivative security, other than a security-based swap, may be deemed the beneficial owner of the reference security. According to the SEC's guidance, such circumstances include when:
  - the derivative provides the holder with exclusive or shared voting or investment power through a contractual term or otherwise;
  - the derivative is acquired in order to divest the holder of beneficial ownership of the security or to prevent the vesting of that beneficial ownership as part of a plan or scheme to evade the reporting requirements; or
  - under the terms of the derivative or an understanding related to it, the holder has a right to acquire beneficial ownership of the security within 60 days or acquires the right to acquire beneficial ownership of the reference security with control purpose, regardless of when the right is exercisable.

- **Amendment to Item 6 of Schedule 13D**. To further clarify the disclosure requirements with respect to derivative securities, the amendments revise Item 6 of Schedule 13D to remove any implication that a person is not required to disclose interests in all derivative securities (including cash-settled derivatives) that use a covered class as a reference security. The adopting release notes that a derivative security need not have originated with the issuer, or otherwise be part of the issuer's capital structure, in order for an Item 6 disclosure obligation to arise.

- **Structured Data Requirement.** The amendments require that Schedule 13D and 13G filings (other than exhibits) be made using a structured, machine-readable data language.

The amendments related to Schedule 13D (except the structured data language requirement) and the extension of the filing cut-off time will be effective on February 5, 2024. Compliance with the revised Schedule 13G filing deadlines will be required as of September 30, 2024. The revised structured data requirements for Schedules 13D and 13G will be effective on December 18, 2024.

The SEC's adopting release is available here, a related fact sheet is available here, and a related press release is available here.

SEC Staff Issues 2024 Examination Priorities

On October 16, 2023, the staff of the SEC's Division of Examinations issued its examination priorities for 2024. The examination priorities include areas of particular interest to regulated entities such as registered investment advisers, registered funds and broker-dealers, including those described below. As in previous years, the staff continues to prioritize examinations of advisers and funds that have never undergone an examination and those that have not been examined for several years.

Investment Advisers

- **Adviser Fiduciary Duties**. The staff stated that it will continue to prioritize examinations of advisers for adherence to their obligation under the duties of care and loyalty. In this regard, examiners will focus on (1) investment advice about products, investment strategies and account types, particularly with respect to complex products, high cost and illiquid products and unconventional investment strategies; (2) processes used to determine that investment advice is in the clients' best interest, including suitability determinations, seeking best execution, evaluating costs and risks, and identifying and addressing conflicts of interest; (3) economic incentives and conflicts of interest associated with advisers that are dually registered as broker-dealers, use affiliated firms to perform client services and have financial professionals servicing both brokerage customers and advisory clients; and (4) disclosures made to investors relating to conflicts of interest.

- **Adviser Compliance Programs**. The staff stated that it remains focused on advisers' compliance programs, with particular focus on (1) marketing practices, including compliance policies and procedures relating to the Marketing Rule (Rule 206(4)-1), Form ADV disclosure of marketing-related information and maintaining substantiating evidence of marketing processes and other required books and records; (2) compensation arrangements, including adherence to fiduciary obligations particularly with respect to the receipt of compensation for services or other material payments, alternative ways that advisers attempt to maximize revenue such as bank deposit sweep programs, and fee breakpoint calculation processes; (3) valuations of client investments that are illiquid or difficult to value, such as commercial real estate or private placements; (4) safeguarding controls to protect clients' material non-public information; and (5) regulatory filings, including Form CRS. The staff stated that it is also focused on advisers' policies and procedures to select and use third-party and affiliated service providers, oversee branch offices and obtain informed consent from clients for material changes to advisory agreements.

- **Advisers to Private Funds**. The staff stated that it will continue to focus on advisers to private funds and will prioritize specific topics, such as (1) portfolio management risks relating to recent market volatility and higher interest rates, which may include funds with poor performance, significant withdrawals, valuation issues and those that use leverage or invest in illiquid assets; (2) adhering to contractual requirements for limited partnership advisory committees or similar structures; (3) calculating and allocating private fund fees and expenses; (4) due diligence practices, particularly for assessments of prospective portfolio companies by private equity and venture capital funds; (5) conflicts of interest, controls and disclosures regarding side-by-side management and the use of affiliated service providers; (6) compliance with custody requirements; and (7) policies and procedures for Form PF reporting.

Investment Companies

- **Fund Compliance Programs and Governance Practices**. The staff stated that examinations of registered investment companies will often include an assessment of fund compliance programs and governance practices, including reviews of (1) boards' processes for evaluating and approving advisory and other fund fees, particularly for funds with weaker performance relative to peers; (2) valuation practices; (3) derivatives risk management programs; and (4) liquidity risk management programs.

- **Fees and Expenses**. The staff stated that it may focus on fund fees and expenses, including whether funds have adopted compliance policies and procedures relating to the oversight of advisory fees and properly implemented any fee waivers and reimbursements. The staff stated that a particular focus will be on (1) funds charging different advisory fees to different share classes of the same fund; (2) fund sponsors offering identical strategies through different distribution channels but with differing fee structures; (3) funds with high advisory fees relative to peers; and (4) funds with high fees and expenses, particularly for funds with weaker performance

relative to peers. Examinations will also review the boards' approval of the advisory contract and fund fees.

- **Derivatives Risk Management.** The staff stated that it may also focus on derivatives risk management and whether funds have effectively adopted and implemented compliance policies and procedures relating to the Derivatives Rule (Rule 18f-4), including (1) the adoption and implementation of a derivatives risk management program, board oversight and disclosure of funds' use of derivatives; and (2) funds' procedures for, and oversight of, the valuation of derivative instruments.

Broker-Dealers

- **Regulation Best Interest**. The staff stated that it will continue to prioritize examinations of broker-dealers for adherence to their standard of conduct obligations under Regulation Best Interest, including related compliance policies and procedures. In this regard, the staff stated that it will focus on, among other things (1) recommendations regarding products, investment strategies and account types, particularly with respect to products that are complex, high cost, illiquid, proprietary or invest in microcap securities; (2) disclosures to investors about conflicts of interest; and (3) conflict mitigation practices.

- **Form CRS**. The staff stated that it will review the content of a broker-dealer's relationship summary, including descriptions of (1) the relationships and services that it offers retail customers; (2) fees and costs; and (3) conflicts of interest, as well as whether the broker-dealer discloses any disciplinary history. Examinations will also evaluate whether broker-dealers have met their filing and delivery obligations with respect to Form CRS.

- **Financial Responsibility Rules and Trading Practices**. The staff stated that it will focus on compliance with the Net Capital Rule and the Customer Protection Rule, and review trading practices for compliance with Regulation SHO, Regulation ATS and Rule 15c2-11.

- **Self-Regulatory Organizations, Clearing Agencies and Other Market Participants**. The examination priorities also outline focus areas for examinations of (1) self-regulatory organizations, including national securities exchanges, FINRA and the Municipal Securities Rulemaking Board (MSRB); (2) clearing agencies; and (3) other market participants, including municipal advisors, security-based swap dealers and transfer agents.

- **Risk Areas Impacting Various Market Participants**. Lastly, the staff highlighted examination priorities with respect to significant areas of risk for multiple types of registrants, including (1) information security and operational resiliency; (2) crypto assets and emerging financial technology; (3) regulation systems compliance and integrity; and (4) anti-money laundering.

In closing, the staff stated that although it will allocate significant resources to its stated examination priorities, it will also conduct examinations and devote resources to address new or emerging risks, products and services, market events and investor concerns.

The Division of Examinations' 2024 examination priorities are available here.

Press Releases, Speeches and Other Public Statements

PUBLIC STATEMENTS

SEC's Enforcement Director Comments on CCO Liability, Self-Reporting and Cooperation

In remarks to the New York City Bar Association Compliance Institute on October 24, 2023, the Director of the SEC's Division of Enforcement, Gurbir S. Grewal, commented on certain aspects of compliance enforcement, including cooperation credit and enforcement actions against compliance personnel, among other things.

Cooperation Credit
Emphasizing proactive compliance, including "[t]hrough leadership, training, constant oversight and the right tone at the top," Mr. Grewal stated that if, despite such efforts, a securities law violation is detected, "the best thing to do would be to self-report and cooperate." With respect to cooperation credit, Mr. Grewal stated that the staff has "aggressively rewarded meaningful cooperation, most notably by recommending that the Commission impose substantially reduced penalties—or even no penalties at all." He noted that circumstances or actions that have resulted in reduced or no penalties have included:

- preemptively remediating and ceasing the unlawful behavior;
- proactively providing compensation to victims;
- providing detailed financial analyses, explanations and summaries of factual issues to the staff;
- proactively identifying key documents and witnesses that the staff has not yet identified; and
- facilitating interviews of former employees.

Enforcement Actions against Compliance Personnel
Mr. Grewal asserted that the Enforcement Division "do[es] not second-guess good faith judgments of compliance personnel made after reasonable inquiry and analysis," describing enforcement actions against compliance personnel as "rare." Still, Mr. Grewal identified three situations in which the SEC typically brings enforcement actions against compliance personnel:

- when compliance personnel affirmatively participate in misconduct unrelated to the compliance function;
- when they mislead regulators; and
- when there is a wholesale failure by them to carry out their compliance responsibilities.

In circumstances of apparent "wholesale failures," Director Grewal noted that "there was no education, no engagement and no execution." He reiterated, however, that cases against CCOs are rare, alluding to a "handful" out of the more than 1,000 standalone enforcement proceedings during his tenure, and noted that the staff has "no interest in pursuing enforcement actions taken against compliance personnel who undertake their responsibilities in good faith and based on reasonable inquiry and analysis."

A copy of Director Grewal's remarks is available here.

Investment Services Group Members

Chicago

Joseph M. Mannon, *Co-Chair* . . . . . +1 (312) 609 7883
Cathy G. O'Kelly . . . . . +1 (312) 609 7657
James A. Arpaia . . . . . +1 (312) 609 7618
Christine De Pree . . . . . +1 (312) 609 7740
Deborah B. Eades . . . . . +1 (312) 609 7661
Renee M. Hardt . . . . . +1 (312) 609 7616
Randall M. Lending. . . . . +1 (312) 609 7564
John S. Marten, *Co-Chair, Editor* . . . +1 (312) 609 7753
Maureen A. Miller . . . . . +1 (312) 609 7699
Nathaniel Segal, *Editor*. . . . . +1 (312) 609 7747
Jacob C. Tiedt, *Editor*. . . . . +1 (312) 609 7697
Cody J. Vitello. . . . . +1 (312) 609 7816
Jeff VonDruska . . . . . +1 (312) 609 7563
Junaid A. Zubairi. . . . . +1 (312) 609 7720
Heidemarie Gregoriev . . . . . +1 (312) 609 7817
Adam S. Goldman . . . . . +1 (312) 609 7731
Nicholas A. Portillo . . . . . +1 (312) 609 7665
Mark Quade . . . . . +1 (312) 609 7515
David W. Soden . . . . . +1 (312) 609 7793
Christina V. West . . . . . +1 (312) 609 7567
Jake W. Wiesen . . . . . +1 (312) 609 7838
Kwashay (Shay) Wilkerson . . . . . +1 (312) 609 7855

New York

Wayne M. Aaron. . . . . +1 (212) 407 7640
Jeremy I. Senderowicz. . . . . +1 (212) 407 7740
Laure Sguario. . . . . +1 (212) 407 7746

Washington, DC

Marguerite C. Bateman, *Co-Chair*. . . +1 (202) 312 3033
Todd F. Lurie. . . . . +1 (202) 312 3030
Amy Ward Pershkow . . . . . +1 (202) 312 3360
Bruce A. Rosenblum . . . . . +1 (202) 312 3379
Kimberly Karcewski Vargo . . . . . +1 (202) 312 3385
Liz J. Baxter . . . . . +1 (202) 312 3014
Devin Eager . . . . . +1 (202) 312-3016
Marylyn Harrell . . . . . +1 (202) 312 3367
Elisa Cardano Perez. . . . . +1 (202) 312 3023

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