

1 UNITED STATES PATENT AND TRADEMARK OFFICE

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3
4 BEFORE THE BOARD OF PATENT APPEALS
5 AND INTERFERENCES
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7
8 *Ex parte* ALEJANDRO M. PILATO
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11 Appeal 2007-1553
12 Application 09/650,733
13 Technology Center 3600
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16 Decided: January 10, 2008
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19 Before LINDA E. HORNER, ANTON W. FETTING, and
20 JOSEPH A. FISCHETTI , *Administrative Patent Judges*.
21 FETTING, *Administrative Patent Judge*.

22 DECISION ON APPEAL
23

24
25 STATEMENT OF CASE

26 Alejandro M. Pilato (Appellant) seeks review under 35 U.S.C. § 134 of a Final
27 Rejection of claims 1-139, the only claims pending in this application.

28 We have jurisdiction over the appeal pursuant to 35 U.S.C. § 6.

29 We AFFIRM IN PART and ENTER NEW GROUNDS OF REJECTION
30 UNDER 37 C.F.R. § 41.50(b).

1 The Appellant invented a way to outsource financial functions to an agent. An
2 understanding of the invention can be derived from a reading of exemplary claims
3 1 and 114, which are reproduced below [bracketed matter and some paragraphing
4 added].

5 1. A computer-assisted method
6 for providing financial risk management functions by an agent for
7 each of a plurality of institutional or corporate clients, comprising the
8 activities of:

9 [1] relating to a financial risk management function of each client:

- 10 [a] demonstrating that more than one activity of the agent is
11 transparent to the client;
- 12 [b] receiving financial information at a computer of the agent;
- 13 [c] creating risk management information relating to the
14 financial information;
- 15 [d] analyzing the risk management information in the context of
16 the financial information;
- 17 [e] determining an action based on the analysis;
- 18 [f] facilitating implementation of the action on behalf of the
19 client; and
- 20 [g] communicating with the client through a network one or
21 more activities of the agent.

22
23 114. A computer-assisted method for a client to outsource financial
24 risk management functions to an agent representing a plurality of
25 institutional or corporate clients, comprising the activities of:

26 [1] providing financial information

- 27 [a] on one or more financial risk management functions
- 28 [b] of each client
- 29 [c] to a computer of the agent;

30 [2] enabling the agent

1 [a] to determine an action
2 [b] based on an analysis of risk management information
3 [c] created from the financial information; and
4 [3] allowing the agent
5 [a] to facilitate the implementation of the action.
6

7 This appeal arises from the Examiner's Final Rejection, mailed July 3, 2006.
8 The Appellant filed an Appeal Brief in support of the appeal on October 13, 2006,
9 and the Examiner mailed an Examiner's Answer to the Appeal Brief on November
10 16, 2006. A Reply Brief was filed on January 11, 2007.

11 PRIOR ART

12 The prior art references of record relied upon by the Examiner in rejecting the
13 appealed claims are:

14 Stein 5,684,952 Nov. 4, 1997
15 McMenemy, *Financial Management: An Introduction*, New York, NY, 1999, pp.
16 15-17 and 20-21
17 Heath, *Strategic Issues Management: Organizations and Public Policy Challenges*,
18 Sage Publications, Thousand Oaks, CA, 1997, pp. 86-87
19 Specification, pp. 1-2, as Admitted Prior Art (APA)

20 We also discuss the following art:

21 Levitt, *Speech by SEC Chairman: The Importance of Transparency in America's*
22 *Debt Market*¹, U.S. Securities and Exchange Commission, Sep. 9, 1998

¹ <http://ftp.sec.gov/news/speech/speecharchive/1998/spch218.htm>

1 REJECTION

2 Claims 1-139 stand rejected under 35 U.S.C. § 103(a) as obvious over
3 McMenamin, Heath, APA, and Stein.

4 ISSUE

5 The issue pertinent to this appeal is whether the Appellant has sustained its
6 burden of showing the Examiner erred in rejecting claims 1-139 under 35 U.S.C.
7 § 103(a) as obvious over McMenamin, Heath, APA, and Stein.

8 FACTS PERTINENT TO THE ISSUE

9 The following enumerated Findings of Fact (FF) are believed to be supported
10 by a preponderance of the evidence.

11 *Claim Construction*

12 01. The Specification contains no explicit lexicographic definition of the
13 phrase “financial risk management function.”

14 02. The usual and customary meaning of “risk” is (1) the possibility of
15 suffering harm or loss; danger; (2) a factor, thing, element, or course
16 involving uncertain danger; a hazard; (3) the danger or probability of
17 loss to an insurer; (4) the amount that an insurance company stands to
18 lose; (5) the variability of returns from an investment; (6) the chance of
19 nonpayment of a debt; (7) one considered with respect to the possibility
20 of loss.²

² American Heritage Dictionary of the English Language (4th ed. 2000).

1 *McMenamin*

2 03. The financial management process is of a continuous, cyclical nature.
3 It relies on information as inputs, and proceeds through the stages of (1)
4 financial analysis, (2) financial decision-making, (3) financial planning,
5 and (4) financial control, from which the cyclical process begins again
6 (McMenamin 15:Fig. 1.8 and associated text).

7 04. Financial analysis includes identification of financial problems and
8 risks (McMenamin 15:¶ Financial analysis).

9 05. Financial decision-making is made based on the findings of the review
10 stage and includes strategic investment decision (McMenamin 15:¶
11 Financial decision-making).

12 06. The financial manager will be intimately involved in the financial
13 evaluation and assessment of the options presented, in determining their
14 respective costs, benefits and *risks* (McMenamin 16:Top ¶).

15 07. The decision-making phase will include the determination of the
16 firm's financial objectives. In the context of the financial review,
17 specific financial objectives will be set (McMenamin (16:¶ Financial
18 objective-setting)).

19 08. While it makes sense for a firm to use borrowed money, the firm will
20 not wish to be overly dependent on borrowed money as this increases its
21 financial *risk* (McMenamin 16:Second full ¶ from the bottom).

22 *Heath*

23 09. In managing strategic issues, situation analysis of issues can be
24 segmented into (1) scanning for emerging issues; (2) researching,

1 analyzing, and forecasting the issues; (3) prioritizing the many issues
2 identified by the scanning and research stages; and (4) developing
3 strategic and issue operations or action plans (Heath 86:Top ¶).

4 10. Implementation is a component of strategic issues management
5 (Heath 86:Second ¶).

6 *Stein*

7 11. Stein is directed towards enabling an administrator to monitor and
8 control individual workstations within a network (Stein, col. 1, ll. 10-
9 15).

10 *Admitted Prior Art*

11 12. Outsourcing can be an option for managing non-core, but vital,
12 functions. Outsourcing has grown into an important service industry,
13 particularly for support functions. Typical functions being outsourced
14 are IT maintenance and support, facilities, security, etc. In the financial
15 sector, typical functions being outsourced tend to be restricted to back-
16 office functions such as settlements, clearing, safe custody, etc. More
17 recently, however, all firms have begun to outsource functions that were
18 previously considered too close to either the strategic management of the
19 core business or to the identity of the firm for outsourcing. JP Morgan
20 outsourced both the ownership and management of the buildings from
21 which it operates in the major financial centers (Specification 2:1-11).

22

1 PRINCIPLES OF LAW

2 *Claim Construction*

3 During examination of a patent application, pending claims are given
4 their broadest reasonable construction consistent with the specification. *In*
5 *re Prater*, 415 F.2d 1393, 1404-05 (CCPA 1969); *In re Am. Acad. of Sci.*
6 *Tech Ctr.*, 367 F.3d 1359, 1364 (Fed. Cir. 2004).

7 Limitations appearing in the specification but not recited in the claim are not
8 read into the claim. *E-Pass Techs., Inc. v. 3Com Corp.*, 343 F.3d 1364, 1369 (Fed.
9 Cir. 2003) (claims must be interpreted “in view of the specification” without
10 importing limitations from the specification into the claims unnecessarily)

11 Although a patent applicant is entitled to be his or her own lexicographer of
12 patent claim terms, in *ex parte* prosecution it must be within limits. *In re Corr*,
13 347 F.2d 578, 580 (CCPA 1965). The applicant must do so by placing such
14 definitions in the Specification with sufficient clarity to provide a person of
15 ordinary skill in the art with clear and precise notice of the meaning that is to be
16 construed. *See also In re Paulsen*, 30 F.3d 1475, 1480 (Fed. Cir. 1994) (although
17 an inventor is free to define the specific terms used to describe the invention, this
18 must be done with reasonable clarity, deliberateness, and precision; where an
19 inventor chooses to give terms uncommon meanings, the inventor must set out any
20 uncommon definition in some manner within the patent disclosure so as to give
21 one of ordinary skill in the art notice of the change).

22 *Obviousness*

23 A claimed invention is unpatentable if the differences between it and the
24 prior art are “such that the subject matter as a whole would have been obvious at
25 the time the invention was made to a person having ordinary skill in the art.” 35

1 U.S.C. § 103(a) (2000); *KSR Int'l v. Teleflex Inc.*, 127 S.Ct. 1727 (2007); *Graham*
2 *v. John Deere Co.*, 383 U.S. 1, 13-14 (1966).

3 In *Graham*, the Court held that that the obviousness analysis is bottomed on
4 several basic factual inquiries: “[(1)] the scope and content of the prior art are to be
5 determined; [(2)] differences between the prior art and the claims at issue are to be
6 ascertained; and [(3)] the level of ordinary skill in the pertinent art resolved.” 383
7 U.S. at 17. See also *KSR Int'l v. Teleflex Inc.*, 127 S.Ct. at 1734. “The
8 combination of familiar elements according to known methods is likely to be
9 obvious when it does no more than yield predictable results.” *KSR*, at 1739.

10 “When a work is available in one field of endeavor, design incentives and
11 other market forces can prompt variations of it, either in the same field or in a
12 different one. If a person of ordinary skill in the art can implement a predictable
13 variation, § 103 likely bars its patentability.” *Id.* at 1740.

14 “For the same reason, if a technique has been used to improve one device,
15 and a person of ordinary skill in the art would recognize that it would improve
16 similar devices in the same way, using the technique is obvious unless its actual
17 application is beyond his or her skill.” *Id.*

18 “Under the correct analysis, any need or problem known in the field of
19 endeavor at the time of invention and addressed by the patent can provide a reason
20 for combining the elements in the manner claimed.” *Id.* at 1742.

21 *Automation of a Known Process*

22 It is generally obvious to automate a known manual procedure or mechanical
23 device. Our reviewing court stated in *Leapfrog Enterprises Inc. v. Fisher-Price*
24 *Inc.*, 485 F.3d 1157 (Fed. Cir. 2007) that one of ordinary skill in the art would have
25 found it obvious to combine an old electromechanical device with electronic

1 circuitry “to update it using modern electronic components in order to gain the
 2 commonly understood benefits of such adaptation, such as decreased size,
 3 increased reliability, simplified operation, and reduced cost. . . . The combination
 4 is thus the adaptation of an old idea or invention . . . using newer technology that is
 5 commonly available and understood in the art.” *Id.* at 1163.

6 *Obviousness and Nonfunctional Descriptive Material*

7 Nonfunctional descriptive material cannot render non-obvious an invention that
 8 would have otherwise been obvious. *In re Ngai*, 367 F.3d 1336, 1339 (Fed. Cir.
 9 2004). Cf. *In re Gulack*, 703 F.2d 1381, 1385 (Fed. Cir. 1983) (when descriptive
 10 material is not functionally related to the substrate, the descriptive material will not
 11 distinguish the invention from the prior art in terms of patentability).

12 ANALYSIS

13 *Claims 1-139 rejected under 35 U.S.C. § 103(a) as obvious over McMenamin,*
 14 *Heath, APA, and Stein.*

15 Claims 1, 112-114, and 136-139 are independent. Of these, claims 1, 112, 113,
 16 and 138 require demonstrating that more than one activity is transparent to a client.
 17 The limitations in the bodies of each independent claim are summarized as follows.

<u>Independent Claim</u>								<u>Contains Limitation</u>
<u>1</u>	<u>112</u>	<u>113</u>	<u>114</u>	<u>136</u>	<u>137</u>	<u>138</u>	<u>139</u>	
X	X	X						1) relating to a financial function of each client
						X	X	2) regarding a financial risk management function of a client from a plurality of clients
X	X	X				X		3) demonstrating that more than one activity of the agent is transparent to the client

X	X	X				X	X	4) receiving financial information at a computer of the agent
X	X	X						5) creating risk management information relating to the financial information
X	X	X				X	X	6) analyzing the risk management information in the context of the financial information
X	X	X						7) determining an action based on the analysis
X	X	X	X	X	X	X	X	8) facilitating implementation of the action on behalf of the client
X	X	X					X	9) communicating with the client through a network one or more activities of the agent
								10) providing financial information on one or more financial risk management functions of each client to a computer of the agent
			X	X	X			11) enabling the agent to determine an action based on an analysis of risk management information created from the financial information
			X	X	X			

1

2 The Examiner found that McMenamini describes activities relating to financial
 3 risk management, which is a financial function; receiving financial information;
 4 creating and analyzing risk management information in the context of the financial
 5 information; and determining an action based on the analysis (Limitations 1, 2, 4-7,
 6 and 10-11 in the above table) (Answer 4:Regarding Claim 1 ...). The Examiner
 7 found that McMenamini failed to describe the remaining limitations of claim 1, but
 8 found that one of ordinary skill would have known to automate the steps of
 9 McMenamini (claim preambles) (Answer 5:First full ¶); that one of ordinary skill
 10 would have known to implement the decisions (Limitation 8 in the above table)
 11 described by McMenamini because of the notoriety of implementing decisions as

1 evidenced by Heath (Answer 5:Last ¶ - continuing to Answer 6); that performing a
2 method by an agent (claim preambles) and communicating such activities
3 (Limitation 9 in the above table) is described by the Appellant's admitted prior art
4 (Answer 6:First full ¶); and that transparency in use of a computer (Limitation 3 in
5 the above table) is described by Stein (Answer 6:Last ¶ - continuing on to Answer
6 7).

7 The Appellant presents a 295 page brief to argue against the Examiner's
8 rejections. It is highly repetitious and therefore we will respond to it in a
9 summarized fashion. Regarding the independent claims, the Appellant contends
10 that (1) the rejections are premised upon an improper construction of the phrase
11 "financial risk management" (see e.g., Appeal Br. 35-37); (2) the rejections
12 improperly characterize portions of the Appellant's Specification on pp. 1 and 2 as
13 admitted prior art (see e.g., Appeal Br. 39-40); (3) none of the applied art recites a
14 "financial risk management function" (see e.g., Appeal Br. 40-41); (4) there is no
15 motivation to combine the references (see e.g., Appeal Br. 41-44); (5) there is no
16 reasonable expectation of success from combining the applied art (see e.g., Br. 44-
17 45); (6) the Examiner improperly relied upon *In re Venner*, 262 F.2d 91 (CCPA
18 1958) to support an argument of obviousness to automate (see e.g., Appeal Br. 46);
19 and (7) Stein is an improper reference to show the claim limitation of
20 demonstrating transparency (see e.g., Appeal Br. 46-47).

21 Regarding those independent claims 1, 112, 113, and 138 which require
22 demonstrating that more than one activity is transparent to a client, the Appellant
23 contends that one of ordinary skill would not have selecting anything from Stein,
24 and that the Examiner failed to show otherwise (Appeal Br. 46:Last full ¶). The

1 Examiner responds that one of ordinary skill would have allowed the client to
2 supervise the agent and allow communication (Answer 42:First full ¶).

3 We find that Stein is directed towards enabling an administrator to monitor and
4 control individual workstations within a network (FF 11). Claim element 1.a and
5 the analogous element in claims 112, 113, and 138 require no transparency of
6 supervision and communication as argued by the Examiner, but a demonstration
7 that an activity is transparent within a financial information context. Stein makes
8 no reference to financial transparency. Thus, we find that the Examiner has not
9 shown that it would have been obvious to one of ordinary skill to demonstrate
10 financial transparency as required by independent claim 1, 112, 113, 138, and the
11 claims 2-111 that depend therefrom and the Appellant has met its burden of
12 showing the Examiner erred in rejecting these claims as obvious.

13 As to claims 114, 136, 137, and 139, we find that McMenamin and Heath
14 describe the limitations of these claims as found by the Examiner. We now
15 consider the contentions raised by the Appellant.

16 *Contention - The rejections are premised upon an improper construction of the*
17 *phrase “financial risk management.”*

18 The Appellant contends that the phrase “financial risk management function” is
19 implicitly defined in the Specification (Appeal Br. 35:First through fifth ¶’s). The
20 Appellant points to references to financial functions (Specification 1:5-7);
21 examples of financial functions, including treasury, credit management, risk
22 management, and trading (Specification 2:16-17); and front, middle, and back
23 office financial functions (Specification 3:1-3) to support the contended implicit

1 definition. The Appellant points to no explicit definition in the Specification and
2 we have not found one.³

3 Although an inventor is free to define the specific terms used to describe the
4 invention, this must be done with reasonable clarity, deliberateness, and precision.
5 *In re Paulsen*, 30 F.3d at 1480. The Specification contains no lexicographic
6 definition of “financial risk management” or even “risk.” The usual and customary
7 meaning of risk is the possibility of suffering harm or loss. In financial contexts,
8 this may mean insurance losses, variability of investment returns, chance of
9 nonpayment of debt or one considered with respect to the possibility of loss (FF
10 01-02). Thus, financial risk management is the management of the possibility of
11 financial loss through insurance management, investment management, or debt
12 management.

13 This construction is well within the scope of those portions of the Specification
14 pointed to the Appellant. Management of financial risk is a financial function and
15 would be within the realm of including treasury, credit management, and risk
16 management. Certainly back office operations involved in financial analysis and
17 control would include risk management within their scope.

³ The Appellant also attaches an affidavit as an appendix to the Appeal Brief that refers to the construction of this phrase (Affidavit 2-3:¶ 12). The Appellant does not refer to this affidavit in the Appeal Brief, and the affidavit appears to be directed towards art that is not applied in any of the rejections at issue. Therefore, the construction proffered by the affiant appears to be moot. In any event, the construction suggested by the affiant is one that would limit its scope to a reader of certain books, and such a limited construction is not supported by the Specification.

1 With this construction of financial risk management, McMEnamin's
2 description of the financial management process which determines costs, benefits
3 and risks in the evaluations and assessments of financial planning options is one of
4 managing financial risks. Thus, we cannot say that the rejections are premised
5 upon an improper construction of the limitation of financial risk management.

6 *Contention - the rejections improperly characterize portions of the Appellant's*
7 *Specification on pp. 1 and 2 as admitted prior art.*

8 The Specification states that outsourcing can be an option for managing non-
9 core, but vital, functions. Outsourcing has grown into an important service
10 industry, particularly for support functions. Typical functions being outsourced are
11 IT maintenance and support, facilities, and security. In the financial sector, typical
12 functions being outsourced tend to be restricted to back-office functions such as
13 settlements, clearing, and safe custody. The Specification states that more
14 recently, all firms have begun to outsource functions that were previously
15 considered too close to either the strategic management of the core business or to
16 the identity of the firm for outsourcing. JP Morgan outsourced both the ownership
17 and management of the buildings from which it operates in the major financial
18 centers (FF 12).

19 This is a characterization of the state of the art by the Appellant, and as such is
20 an admission of the state of the art. The Appellant contends that one's own work
21 may not be used as prior art absent some statutory basis (Appeal Br. 40:Second
22 from bottom ¶). A statement by an applicant during prosecution identifying the
23 work of another as "prior art" is an admission that that work is available as prior art
24 against the claims, regardless of whether the admitted prior art would otherwise
25 qualify as prior art under the statutory categories of 35 U.S.C. § 102. *Riverwood*

1 *Int'l Corp. v. R.A. Jones & Co.*, 324 F.3d 1346, 1354 (Fed Cir. 2003). Thus, the
2 Appellant has not shown that those statements characterized in the Specification as
3 the state of the art by others is not admitted prior art.

4 *Contention – none of the art recites a financial risk management function.*

5 McMenamin describes the financial management process as one that
6 determines costs, benefits and risks in the evaluations and assessments of financial
7 planning options. This description of financial management includes managing
8 financial risks. Thus, we find that McMenamin does recite a function of financial
9 risk management.

10 *Contention – there is no motivation to combine the references.*

11 McMenamin describes a financial planning and management process, one that
12 inherently scans for emerging financial issues for evaluation and assessment.
13 Heath describes the process of managing strategic issues such as the financial
14 issues surfaced by the process of McMenamin. Thus, at least McMenamin and
15 Heath are complementary and would therefore have been combined to effectively
16 implement plans addressing strategic financial issues by one of ordinary skill.
17 Although for the reasons we found *supra*, we agree that there would have been no
18 motivation to combine Stein with McMenamin and Heath, the rejection of claims
19 114, 136, 137, and 139 do not require Stein, although the Examiner nominally
20 applied it, apparently as an expedient.

21 The Appellant also introduces several additional arguments under the rubric of
22 lack of motivation. In particular, the Appellant contends that computer assisted
23 methods or agent functions are not taught by McMenamin (Appeal Br. 41:Last full
24 ¶). The Appellant also contends that Heath is not in the same field of endeavor as
25 the claimed invention (Appeal Br. 42-43).

1 It is generally obvious to automate a known manual procedure or mechanical
2 device. *See Leapfrog Enterprises Inc. v. Fisher-Price Inc.* 485 F.3d 1157 (Fed.
3 Cir. 2007). The admitted prior art demonstrates that outsourcing services to agents
4 was known at the time of the invention (FF 12). Although the admitted prior art
5 does not state that outsourcing was used for financial risk management, “[w]hen a
6 work is available in one field of endeavor, design incentives and other market
7 forces can prompt variations of it, either in the same field or a different one. If a
8 person of ordinary skill can implement a predictable variation, § 103 likely bars its
9 patentability. For the same reason, if a technique has been used to improve one
10 device, and a person of ordinary skill in the art would recognize that it would
11 improve similar devices in the same way, using the technique is obvious unless its
12 actual application is beyond his or her skill.” *KSR*, 127 S. Ct. at 1740. The
13 techniques of hiring an agent are sufficiently similar among various markets, that
14 one of ordinary skill would have known how to hire an agent for financial risk
15 management at the time of the invention. Also, as noted in *KSR*, when a work is
16 available in one field of endeavor, design incentives and other market forces can
17 prompt variations of it, either in the same field or a different one. Clearly strategic
18 issues management described by Heath is a critical aspect of financial risk
19 assessment described by McMEnamin. Further, Heath is applied only as evidence
20 of the common sense proposition that having made a plan as in McMEnamin, it
21 ought to be implemented. This is hardly a novel idea. “The obviousness analysis
22 cannot be confined by a formalistic conception of the words teaching, suggestion,
23 and motivation, or by overemphasis on the importance of published articles and the
24 explicit content of issued patents. The diversity of inventive pursuits and of
25 modern technology counsels against limiting the analysis in this way. In many
26 fields it may be that there is little discussion of obvious techniques or

1 combinations, and it often may be the case that market demand, rather than
2 scientific literature, will drive design trends.” *Id.* at 1741.

3 *Contention – there is no reasonable expectation of success.*

4 It is difficult to fathom how there can be no reasonable expectation of success
5 in outsourcing a service. One calls the agent, tells them what one wants and gets
6 out of the way. The claims do not predict the actual outcomes of the outsourcing,
7 but only the act of having a service outsourced, so the success of the agent is
8 irrelevant.

9 The Appellant contends that the art provides only general guidelines (Appeal
10 Br. 45:Second to bottom ¶). To which we respond that in outsourcing, not much
11 more is needed. One calls the agent, tells them what one wants and gets out of the
12 way. The Appellant provides no contention that the process of commissioning an
13 agent is unduly difficult or unpredictable. Thus we cannot say that there is no
14 reasonable expectation of success.

15 *Contention –the Examiner improperly relied upon In re Venner.*

16 The Examiner cited *Venner* for the proposition that it is obvious to automate a
17 process (Answer 5). The Appellant spends considerable ink arguing that *Venner*
18 was overruled and is not applicable (Appeal Br. 41-42 and 46). We need not
19 consider the pertinence of *Venner* because our reviewing court has recently spoken
20 again on the obviousness to automate. A combination that is the adaptation of an
21 old idea or invention using newer technology that is commonly available and
22 understood in the art would have been obvious to one of ordinary skill in the.
23 *Leapfrog, id* at 1163. Thus, irrespective of the status of *Venner*, our reviewing
24 court has held that automation of what is known is obvious, which supports the
25 Examiner’s findings in which the Examiner cited *Venner*.

1 Thus, as to independent claims 114, 136, 137 and 139, the Appellant has not
2 met its burden of showing the Examiner erred in rejecting these claims.

3 *Dependent claims 115-135*

4 Dependent claims 115-135 recite the added limitations as follows (most of the
5 added limitations recited the acquisition of information):

6 receiving risk management information generated by the agent at the
7 client (claim 115).

8 receiving the agent's analysis at the client (claim 116).

9 receiving an action instruction at the client (claim 117).

10 receiving an action recommendation at the client (claim 118).

11 receiving a notification at the client of an action that will be
12 implemented by the agent (claim 119).

13 receiving a notification at the client of an implemented action (claim
14 120).

15 requesting notification of an effect of one or more actions of the agent
16 on the risk management analysis (claim 124).

17 requesting notification of the effect of one or more alternative actions
18 of the agent on the risk management information (claim 125).

19 requesting information on one or more reasons behind an action
20 determined by the agent (claim 126).

21 requesting an audit log of one or more of historical activities of the
22 agent on behalf of the client (claim 127).

23 requesting a review of one or more of historical activities of the agent
24 (claim 128).

25 providing financial information to the agent (claim 129).

26 new financial information to the agent based on a review of one or
27 more of historical activities of the agent (claim 130).

28 Having a client receive information from an outsourced service is simply
29 feedback that is inherent in any rational employment of outsourced services.

1 Requesting notification is the act by which such reception occurs. While an
2 infinite number of information requests might be envisaged, any that reasonably
3 would provide insight as to the efficacy of the outsourced services would be
4 common sense and therefore obvious. *See KSR*, 127 S. Ct. at 1742. All of the
5 requests recited in these claim limitation are for financial, historical, or
6 implementation information that shed light on the efficacy of that which is
7 outsourced, all of which would have been within the knowledge of one of ordinary
8 skill to ask an outsourcing agent.

9 Several claims deal with using a network for communication:

10 accessing information across a network on one or more of the agent's
11 activities (claim 121).

12 monitoring across a network one or more of the agent's activities
13 (claim 122).

14 silently monitoring across a network one or more of the agent's
15 activities (claim 123).

16 the financial information is provided through a network (claim 135).

17 Certainly the notoriety of financial communication networks in an era of
18 ATMs and online day trading (Schwab⁴ began in 1995) is far too extensive to
19 seriously question. Further, under *Leapfrog*, it would have been obvious to use
20 electronic technology for communication.

21 Finally, several claims deal with the power granted to the agent to whom
22 services are outsourced:

23 removing the agent's authority to undertake any action on behalf of
24 the client (claim 131).

⁴ See <http://www.aboutschwab.com/about/overview/history.html>

1 removing the authority of the agent in connection with one or more
2 actions (claim 132).

3 requesting the agent to halt one or more actions (claim 133).

4 requesting, through a network, the agent to halt one or more actions
5 (claim 134).

6 These represent elementary examples of the powers one exercises over an
7 agent and therefore would have been known to one of ordinary skill. Certainly no
8 one with a modicum of skill would allow an agent to run rampant without
9 exercising at least the level of discretionary control such as these.

10 The Appellant contended the rejections of these claims in Appeal Br. 230-245.
11 The contentions generally argued improper motivation to combine, which we
12 responded to *supra*, and improper grouping of claims. We have grouped the
13 claims above to more readily show the common features among these claims and
14 how we found them to be obvious.

15 NEW GROUND OF REJECTION

16 We enter a new ground of rejection of claims 1-112, 114-136, 138, and 139
17 under 35 U.S.C. § 101 as directed to nonstatutory subject matter.

18 ADDITIONAL PRINCIPLES OF LAW

19 35 U.S.C. §101 provides:

20 Whoever invents or discovers any new and useful process, machine,
21 manufacture, or composition of matter, or any new and useful
22 improvement thereof, may obtain a patent therefor, subject to the
23 conditions and requirements of this title.

24 This has been interpreted as follows:

25 In choosing such expansive terms as ‘manufacture’ and ‘composition
26 of matter,’ modified by the comprehensive ‘any,’ Congress plainly
27 contemplated that the patent laws would be given wide scope.

1 *Diamond v. Chakrabarty*, 447 U.S. 303, 308 (1980).

2 That wide scope nevertheless excludes laws of nature, natural phenomena, and
3 abstract ideas. “Such discoveries are ‘manifestations of . . . nature, free to all men
4 and reserved exclusively to none.’” *Id.* at 309, (quoting *Funk Bros. Seed Co. v.*
5 *Kalo Inoculant Co.*, 333 U.S. 127, 130 (1948)). “Phenomena of nature, though just
6 discovered, mental processes, and abstract intellectual concepts are not patentable,
7 as they are the basic tools of scientific and technological work.” *Gottschalk v.*
8 *Benson*, 409 U.S. 63, 67 (1972).

9 Thus, the claimed invention as a whole must accomplish a practical
10 application. That is, it must produce a "useful, concrete and tangible result." *State*
11 *Street Bank & Trust Co. v. Signature Financial Group, Inc.*, 149 F.3d 1368, 1373
12 (Fed. Cir. 1998). The purpose of this requirement is to limit patent protection to
13 inventions that possess a certain level of "real world" value, as opposed to subject
14 matter that represents nothing more than an idea or concept, or is simply a starting
15 point for future investigation or research. *See e.g., Brenner v. Manson*, 383 U.S.
16 519, 528-36 (1966); *In re Ziegler* 992, F.2d 1197, 1200-03 (Fed. Cir. 1993)). A
17 process that consists solely of the manipulation of an abstract idea is not concrete
18 or tangible. *See In re Warmerdam*, 33 F.3d 1354, 1360 (Fed. Cir. 1994). *See also*
19 *In re Schrader*, 22 F.3d 290, 295 (Fed. Cir. 1994).

20 ANALYSIS

21 Claims 1-111, 114-135, 138 and 139 are directed toward methods of creating,
22 analyzing and receiving risk information and communicating activities. Claims
23 112 and 136 are directed towards software instructions to perform these methods.
24 The claims are not directed towards improving the mechanisms of creation,
25 analysis, reception, and communication of information, but just towards the

1 application of these generic activities to financial risk management. Financial
2 information is the epitome of abstract information in itself. Communicating
3 activities is not performance of the activities themselves, but merely information
4 about the activities that is transmitted. Creating, analyzing, receiving and
5 communicating abstract information does not make the abstract information
6 concrete and tangible, nor does it produce a concrete and tangible result.
7 Automating the process does not make the results any more concrete or tangible
8 either.

9 At the end of the day, these claims do no more than indicate information that
10 an agent communicates to a client, and the instructions that the client may give to
11 the agent. Hence the methods produce no useful, concrete and tangible result, but
12 only provide a communication of such intellectual pursuits between two parties.

13 **ADDITIONAL NEW GROUND OF REJECTION**

14 We enter a new ground of rejection of claims 1-139 under 35 U.S.C. § 103(a)
15 as obvious over McMenamin, Heath, APA, and Levitt.

16 **ADDITIONAL FINDINGS OF FACT (FF)**

17 We make the following additional enumerated findings of fact, which are
18 supported by at least a preponderance of the evidence.

19 13. Levitt describes the necessity for transparency in financial
20 transactions. He states that “[t]ransparency, disclosure and
21 accountability aren't just catchwords. They are the essential ingredients
22 to confidence. And without it, markets can neither sustain long-term
23 growth nor adapt to a rapidly changing environment (Levitt 2:Third ¶).

1 ANALYSIS

2 As we found above, the art applied by the Examiner described all of the
3 limitations of the independent claims, except for those independent claims 1, 112,
4 113, and 138 where the art did not describe demonstrating that more than one
5 activity is transparent to a client. Levitt describes the paramount necessity for
6 transparency, disclosure and accountability in financial transactions (FF 13). Thus
7 one of ordinary skill would have known to meet this professed necessity by
8 demonstrating the transparency of the financial transaction activities that would be
9 performed for financial risk management. Therefore, as to the independent claims
10 1, 112-114, and 136-139, the claimed subject matter would have been obvious to
11 one of ordinary skill over McMenamin, Heath, Levitt and the admitted prior art.

12 As to dependent claims 2-111, they are more readily treated according to their
13 limitations in common.

14 *Claims specifying the information*

15 Several claims added the limitation that specific information was provided:

16 includes providing a notification. (claim 9)

17 includes providing a report. (claim 10)

18 includes providing an analysis. (claim 11)

19 includes providing information. (claim 12)

20 comprising reporting one or more effects of the agent's action on the
21 risk management information. (claim 21)

22 comprising reporting one or more effects of an alternative action to
23 the agent's action on the risk management information. (claim 22)

24 comprising reporting one or more reasons behind an action
25 determined by the agent. (claim 23)

26 includes providing an audit log of one or more historical activities of
27 the agent on behalf of the client. (claim 24)

1 includes informing the client of results of reviews of one or more of
2 historical activities of the agent. (claim 25)

3 includes financial guidelines. (claim 39)

4 includes one or more benchmarks. (claim 40)

5 includes action guidelines. (claim 41)

6 includes market risk limits. (claim 42)

7 includes credit risk limits. (claim 43)

8 includes liquidity guidelines. (claim 44)

9 includes maturity guidelines. (claim 45)

10 includes credit guidelines. (claim 46)

11 includes detailed information on financial instruments relevant to a
12 financial risk management function. (claim 96)

13 includes historical market data relevant to the financial risk
14 management function. (claim 97)

15 includes current market data relevant to the financial risk management
16 function. (claim 98)

17 includes economic information relevant to the financial risk
18 management function. (claim 99)

19 includes information relevant to the financial risk management
20 function. (claim 100)

21 includes strategic financial objectives. (claim 101)

22 The nature of information that is provided does not alter the function of the
23 claimed methods. It is nonfunctional descriptive material.

24 *Nonfunctional Descriptive Material*

25 Descriptive material can be characterized as either “functional descriptive
26 material” or “nonfunctional descriptive material.” Exemplary “functional

1 descriptive material” consists of data structures⁵ and computer programs, which
2 impart functionality when employed as a computer component. “Nonfunctional
3 descriptive material” includes but is not limited to music, literary works and a
4 compilation or mere arrangement of data.

5 When presented with a claim comprising descriptive material, an Examiner
6 must determine whether the claimed nonfunctional descriptive material should be
7 given patentable weight. The Patent and Trademark Office (PTO) must consider
8 all claim limitations when determining patentability of an invention over the prior
9 art. *In re Gulack*, 703 F.2d 1381, 1385 (Fed. Cir. 1983). The PTO may not
10 disregard claim limitations comprised of printed matter. *See Gulack*, 703 F.2d at
11 1384; *see also Diamond v. Diehr*, 450 U.S. 175, 191 (1981). However, the
12 examiner need not give patentable weight to descriptive material absent a new and
13 unobvious functional relationship between the descriptive material and
14 the substrate. *See In re Lowry*, 32 F.3d 1579, 1583-84 (Fed. Cir. 1994); *In re Ngai*,
15 367 F.3d 1336, 1338 (Fed. Cir. 2004).

16 Thus, when the prior art describes all the claimed structural and functional
17 relationships between the descriptive material and the substrate, but the prior art
18 describes a different descriptive material than the claim, then the descriptive
19 material is nonfunctional and will not be given any patentable weight. That is, we
20 conclude that such a scenario presents no new and unobvious functional
21 relationship between the descriptive material and the substrate.

22 Thus, in the context of the above claims which describe the nature of the
23 information conveyed, which is nonfunctional descriptive material, this presents no

⁵ The definition of “data structure” is “a physical or logical relationship among data elements, designed to support specific data manipulation functions.” *The New*

1 new and nonobviousness relationship. We further find that all of the information
2 so described, e.g. reports, analyses, guidelines, benchmarks, relevant data and audit
3 logs, are well within the scope of what financial managers would typically expect
4 to communicate.

5 *Claims specifying the financial risk management function*

6 Many claims simply further specify the nature of the financial risk
7 management function:

8 includes short-term funding and cash management. (claim 47)

9 includes cash flow management. (claim 48)

10 includes liquidity management. (claim 49)

11 includes cash management. (claim 50)

12 includes investment management. (claim 51)

13 includes repo (repurchase agreement) funding. (claim 52)

14 includes debt management. (claim 53)

15 includes debt issuance. (claim 54)

16 includes asset and liability management. (claim 55)

17 includes asset and liability management and wherein the assets
18 include insurance premia. (claim 56)

19 includes asset and liability management and wherein the liabilities
20 include insurance claims. (claim 57)

21 includes asset and liability management and wherein the assets
22 include life insurance premia. (claim 58)

23 includes asset and liability management and wherein the liabilities
24 include life insurance claims. (claim 59)

25 includes asset and liability management and wherein the liabilities
26 include pension claims. (claim 60)

- 1 includes asset and liability management and wherein the liabilities
- 2 include legal claims. (claim 61)
- 3 includes asset and liability management wherein the assets include
- 4 leases. (claim 62)
- 5 includes asset and liability management wherein the liabilities include
- 6 leases. (claim 63)
- 7 includes asset and liability management wherein the assets include
- 8 operational cashflows. (claim 64)
- 9 includes asset and liability management wherein the liabilities include
- 10 operational cashflows. (claim 65)
- 11 includes treasury management. (claim 66)
- 12 includes credit management. (claim 67)
- 13 includes credit spread trading. (claim 68)
- 14 includes loan portfolio management. (claim 69)
- 15 includes equity portfolio management. (claim 70)
- 16 includes fixed income portfolio management. (claim 71)
- 17 includes funding. (claim 72)
- 18 includes collateral management. (claim 73)
- 19 includes the lending of securities. (claim 74)
- 20 includes the borrowing of securities. (claim 75)
- 21 includes counterparty credit exposure management. (claim 76)
- 22 includes financial risk management. (claim 77)
- 23 includes market risk management. (claim 78)
- 24 includes credit risk management. (claim 79)
- 25 includes commodity price risk management. (claim 80)
- 26 includes liquidity risk management. (claim 81)
- 27 includes operational risk management. (claim 82)
- 28 includes management of insurable risks. (claim 83)
- 29 includes electricity price risk management. (claim 84)

1 includes pension fund management. (claim 85)
2 includes real estate management. (claim 86)
3 includes hedging. (claim 87)
4 includes dynamic hedging. (claim 88)
5 includes mortgage pre-payment risk management. (claim 89)
6 includes front-office activities. (claim 90)
7 includes middle-office activities. (claim 91)
8 includes back-office activities. (claim 92)
9 includes front-office and middle-office activities. (claim 93)
10 includes middle-office and back-office activities. (claim 94)
11 includes front-office, middle-office and back-office activities. (claim
12 95)

13 As such, these claims simply present different market contexts within which
14 the steps of claim 1 are performed. “When a work is available in one field of
15 endeavor, design incentives and other market forces can prompt variations of it,
16 either in the same field or a different one. If a person of ordinary skill can
17 implement a predictable variation, § 103 likely bars its patentability.” *KSR, id.* at
18 1740. One of ordinary skill in financial risk management would have considered
19 all of these financial risk niches to be within the scope of what might be managed
20 under financial risk management, since they are all known aspects of financial risk
21 management. Certainly one of ordinary skill within any one of these niches would
22 have both known of that niche and considered that niche to be within the scope of
23 financial risk management. Further, none of these niches have any functional
24 bearing on the steps performed in claim 1, but act only to limit the field of use in
25 which the steps of claim 1 are performed.

26 *Claims specifying the clients*

27 Several of the claims limit the nature of the clients:

1 includes departments of the client. (claim 102)

2 includes subsidiaries of the client. (claim 103)

3 includes affiliates of the client. (claim 104)

4 includes clients of the client. (claim 105)

5 includes regulators of the client. (claim 106)

6 includes auditors of the client. (claim 107)

7 includes agents of the client. (claim 108)

8 includes advisors of the client. (claim 109)

9 includes counterparties of the client. (claim 110)

10 includes shareholders of the client. (claim 111)

11 As with the prior group of claims that limited the nature of the risk, these
12 limitations do no more than limit the market of clients for which the steps are
13 performed and thus the field of use. One of ordinary skill in any field of financial
14 services outsourcing, including financial risk management, would have considered
15 all of these clients to be within the scope of those who might be served, since they
16 are all parties with obvious interests in the financial status of an enterprise.

17 *Claims enabling the information*

18 Several of the claims require enabling or allowing the client to get information:

19 includes enabling the client to access information regarding one or
20 more activities of the agent. (claim 13)

21 includes enabling the client to access information across a network
22 regarding one or more activities of the agent. (claim 14)

23 includes allowing the client to monitor across a network one or more
24 activities of the agent. (claim 15)

25 includes allowing the client to monitor in real-time across a network
26 one or more activities of the agent. (claim 16)

27 includes allowing the client to monitor in near-real-time across a
28 network one or more activities of the agent. (claim 17)

1 Enabling such monitoring is at least suggested by Levitt’s description of the
2 necessity for transparency. Thus, this claimed subject matter would have been
3 obvious to provide such transparency.

4 *Claim specifying feedback*

5 One claim requires feedback:

6 includes seeking feedback from the client on reviews of one or more
7 of historical activities of the agent. (claim 26)

8 McMenamin describes the cyclical nature of the financial management process
9 which includes feedback from information fed into the analysis. Since the
10 activities performed in financial operations would produce such information,
11 feedback from those activities would be produced in the normal course of financial
12 management. Thus such feedback would have been an inherent and, therefore,
13 obvious step in financial management of McMenamin.

14 *Claims specifying agent attributes*

15 Two claims limit the freedom of the agent:

16 wherein the agent is conflict-free. (claim 27)

17 comprising the agent receiving authority to implement the action on
18 behalf of the client. (claim 28)

19 Since conflicts of interest are generally discouraged if not prohibited in any
20 field of agency, and agents necessarily must have the authority to implement
21 whatever they are to implement, these limitations are obvious in view of the law
22 and practice of agency in general.

23 *Claims specifying implementation attributes*

24 Several claims limit the nature of implementing actions:

25 includes implementing the action on behalf of the client. (claim 3)

- 1 includes instructing the client to implement the action. (claim 4)
- 2 includes recommending that the client implement the action. (claim 5)
- 3 comprising notifying the client that an action will be implemented by
- 4 the agent. (claim 6)
- 5 comprising notifying the client of the action implemented by the
- 6 agent. (claim 7)
- 7 comprising receiving notification from the client of an action
- 8 implemented by the client. (claim 8)
- 9 comprising the client agreeing to implement actions recommended by
- 10 the agent. (claim 29)
- 11 comprising the client agreeing to implement actions instructed by the
- 12 agent. (claim 30)

13 The whole point of planning is for implementation. Heath explicitly recites the
14 need for implementation (FF 10). Thus, implementation by any party involved in a
15 plan, including the client or the agent, and instructing, notifying or otherwise
16 communicating the actions for implementation, would have been obvious parts of
17 the step of implementation of plans such as those in McMenamini to one of
18 ordinary skill. As to which party will perform the implementation and how that is
19 communicated, the planning process, generally described by McMenamini, hashes
20 out such details as a matter of course.

21 *Claims specifying a result*

22 Six claims specify the nature of a result of the steps in claim 1:

- 23 results in the negotiation of the terms of a trade. (claim 31)
- 24 includes an identification of a best rate or price at which the trade can
- 25 be executed. (claim 32)
- 26 results in execution of a trade. (claim 34)
- 27 results in execution of a trade with a third party. (claim 35)
- 28 results in execution of a trade by the agent. (claim 36)

1 results in execution of a trade by the client. (claim 37)

2 Since terms of a trade or a best price are typical goals of financial planning
3 such as that described by McMEnamin, one of ordinary skill would expect the first
4 two results from the planning process of McMEnamin. “A person of ordinary skill
5 is also a person of ordinary creativity, not an automaton.” *KSR, id.* at 1742. It
6 would take a minimum of creativity to see that terms of trade and optimal pricing
7 are goals of financial planning. Thus these would have been obvious for being
8 typical goals of financial planning. As to the results of executions of trades, any
9 financial risk management surrounding the use of financial securities or derivatives
10 would inherently incorporate these results as these are the mechanisms by which
11 financial securities are transacted. The parties executing the trades recited in the
12 claims are those one of ordinary skill would have known to be candidates.

13 “Common sense teaches ... that familiar items may have obvious uses” *KSR, id.* at
14 1742. Similarly, common parties to transactions can be expected to be parties to
15 those transactions.

16 More to the point, there is no functional connection between the steps of claim
17 1 and these results. Thus these results are not functionally provided by the steps of
18 claim 1 and are therefore aspirational rather than functional limitations. The
19 limitations are achieved by happenstance of what an agent does outside of the
20 scope of claim 1, not by operation of claim 1’s steps. Thus, these limitations are
21 functionally no different from those in which an agent is instructed by
22 nonfunctional descriptive material to achieve such results. As such, these
23 limitations deserve minimal patentable weight.

24 *Claims specifying automation*

1 Several claims require the use of a communication network or of automation of
2 the determining and implementing steps:

3 financial information is received through a network. (claim 2)
4 includes reporting to the client across a network one or more activities
5 of the agent. (claim 18)

6 includes reporting to the client in real-time across a network one or
7 more activities of the agent. (claim 19)

8 includes reporting to the client in near-real-time across a network one
9 or more activities of the agent. (claim 20)

10 said activity of determining the action is performed automatically.
11 (claim 33)

12 implemented automatically. (claim 38)

13 A combination that is the adaptation of an old idea or invention using newer
14 technology that is commonly available and understood in the art is obvious to one
15 of ordinary skill. *See Leapfrog, id.* at 1163. As we found with respect to claims
16 115-135, *supra*, the notoriety of financial communication networks in an era of
17 ATMs and online day trading is far too extensive to seriously question. Electronic
18 communication was far too extensive at the time of the invention to seriously
19 question its obviousness to one of ordinary skill. The aspect of real-time reporting
20 is in the eye of the beholder. E-mail and instant messaging have made real-time
21 communication a habit for most of the electronically served population, and the
22 speed with which financial information is known to grow stale makes near-real
23 time communication obligatory and therefore obvious to one of ordinary skill. As
24 to automation of implementation and determination, the claims do not specify the
25 nature of the automation, and in an era of graphical user interfaces with radio
26 buttons and control boxes, entering data related to the information in claim 1 can
27 be construed as parts of the determining and implementing steps.

1 Thus, all of the dependent claims 2-111 would have been obvious to one of
2 ordinary skill over McMEnamin, Heath, Levitt, and the admitted prior art, in view
3 of the knowledge of one of ordinary skill in financial risk management. Claims
4 115-135 were found to be obvious over McMEnamin, Heath, and the admitted
5 prior art, in view of the knowledge of one of ordinary skill in financial risk
6 management in the analysis of the Examiner's rejections, *supra*, and those findings
7 are applicable here as well.

8 CONCLUSIONS OF LAW

9 The Appellants have sustained their burden of showing that the Examiner erred
10 in rejecting claims 1-113 and 138, but have not sustained their burden of showing
11 that the Examiner erred in rejecting claims 114-137 and 139 under 35 U.S.C. §
12 103(a) as unpatentable over the prior art.

13 We enter a new ground of rejection of claims 1-112, 114-136, 138 and 139
14 under 35 U.S.C. § 101 as directed to nonstatutory subject matter.

15 We enter a new ground of rejection of claims 1-139 under 35 U.S.C. § 103(a)
16 as obvious over McMEnamin, Heath, APA, and Levitt.

17 DECISION

18 To summarize, our decision is as follows:

- 19 • The rejection of claims 1-113 and 138 under 35 U.S.C. § 103(a) as obvious
20 over McMEnamin, Heath, APA, and Stein is not sustained.
- 21 • The rejection of claims 114-137 and 139 under 35 U.S.C. § 103(a) as
22 obvious over McMEnamin, Heath, APA, and Stein is sustained.
- 23 • A new ground of rejection of claims 1-112, 114-136, 138 and 139 under 35
24 U.S.C. § 101 as directed to nonstatutory subject matter is made pursuant to

1 37 C.F.R. § 41.50(b).

- 2 • A new ground of rejection of claims 1-139 under 35 U.S.C. § 103(a) as
3 obvious over McMenammin, Heath, APA, and Levitt is made pursuant to
4 37 C.F.R. § 41.50(b).

5 This decision contains new grounds of rejection pursuant to 37 C.F.R.
6 § 41.50(b) (2007). 37 C.F.R. § 41.50(b) provides "[a] new ground of rejection
7 pursuant to this paragraph shall not be considered final for judicial review."

8 37 C.F.R. § 41.50(b) also provides that Appellant, WITHIN TWO
9 MONTHS FROM THE DATE OF THE DECISION, must exercise one of the
10 following two options with respect to the new grounds of rejection to avoid
11 termination of the appeal as to the rejected claims:

12 (1) *Reopen prosecution*. Submit an appropriate amendment of
13 the claims so rejected or new evidence relating to the claims so
14 rejected, or both, and have the matter reconsidered by the Examiner,
15 in which event the proceeding will be remanded to the Examiner. . . .

16
17 (2) *Request rehearing*. Request that the proceeding be reheard
18 under § 41.52 by the Board upon the same record. . . .
19

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U.S. Securities and Exchange Commission

Speech by SEC Chairman: The Importance of Transparency In America's Debt Market

Remarks by

Chairman Arthur Levitt

U.S. Securities and Exchange Commission

At the Media Studies Center, New York, N.Y.

September 9, 1998

Thank you very much. Bob, thank-you for that generous introduction. I also want to thank the Freedom Forum and the staff of the Media Studies Center for all of their hard work in making this event possible.

As I walked in to the auditorium, I couldn't help but think back to my first job out of college as a young reporter for the *Berkshire Eagle* in Massachusetts. Although I spent most of my professional life on Wall Street, I never lost my interest in the media. After I left Wall Street, I found myself, once again, as a member of the press. But this time I wasn't a reporter. Nobody would hire me. Instead, I became the owner of *Roll Call* – a newspaper which covers Congress.

Through those experiences, I observed first-hand the indispensable role the press plays in a democratic society. Now, as Chairman of the SEC, I see how quality financial news reporting brings emerging issues to our attention, augments our actions and arms investors with the knowledge to make informed decisions.

By reporting on issues ranging from price fixing in equities to microcap stock fraud to the disclosure of mutual fund fees, the press has made all of us more responsive – and more accountable – from the broker-dealer in New York to the fund manager in Boston to the government regulator in Washington.

The press and the SEC share a broad mission: to make available to the public vital, reliable and timely information to help ensure that officials and institutions – public or private – fulfill their fiduciary obligations and accept responsibility for their decisions and results. And so, I can think of no better place than the Media Studies Center to discuss the importance of transparency and disclosure – particularly as it relates to America's long-term financial health.

First, I am concerned that certain mortgage-backed securities are being sold to individual investors without those investors fully understanding the risks involved. It's likely that many individual investors are not even aware of the variables that influence the return and duration of their investments.

I'm principally referring to the sale of collateralized mortgage obligations, or CMOs. Issued by either a federal agency or private corporation, a CMO is a bond backed by a large pool of home mortgages.

These are complex financial instruments. Even professionals require sophisticated analytical tools to evaluate them properly. I doubt that many individual investors realize exactly what they have purchased. I am also very troubled by reports that brokers may be marketing only the higher-risk classes – or tranches – to individual investors, while lower-risk classes are sold exclusively to institutions.

Second, we found anecdotal evidence of the possible misuse of inside information in the high-yield market. We were told that investment bankers and institutional investors who buy high-yield corporate bonds sometimes participate in syndicated loans for those same corporations issuing high-yield debt.

These participants in syndicated loans are entitled to send representatives to regular meetings with the borrower's management and bankers. Fine. But if confidential information from internal discussions in these meetings is being used or improperly leaked – affecting the prices of these companies' bonds – that would be unacceptable.

As I have said time and time before, insider trading – whatever its form – is plain and simply, wrong.

These matters are now under investigation and you can be sure that if we discover abuses, we will be quick to take action.

Conclusion

There is little doubt that the debt market is vital; that it has experienced strong growth; and, in many respects, is the backbone of corporate development in this country. But, these facts by no means guarantee its future prominence.

The imperatives of globalization and rapid advancements in technology have put a premium on information. Governments analyze and respond to it; the press reports and editorializes it; companies sell it; markets act on it; and investors rely on it.

Today, market information moves at the speed of light. The availability of accurate information to ensure the long-term stability of our markets has never been more important. The corporate debt market is not immune from these realities. And it would be folly to think otherwise.

I simply refuse to accept that this market cannot be as transparent as other markets. That logic runs counter to the values of trust, accountability, innovation and confidence that have been the hallmarks of America's

bicycles – or even telephones. Everything they need is at their fingertips.

Technology is revolutionizing how business is being conducted. But the corporate debt market remains one of the last major markets in the United States to not have some type of electronic price disclosure system. I think it is fair to say that the recent volatility in the markets underscores the need for greater price transparency in this market.

While everyone is familiar with the activity in the stock markets on August 31, most are probably unaware that there was virtually no buyer interest in the corporate bond market that same day. This lack of liquidity was readily apparent to the professional trader, but it was not known to the general public until reported by the press the following day.

What was not broadly reported – even after the facts – was the difficulty in the pricing of high-yield corporate securities. This, in turn, has a significant impact on a well-defined segment of mutual funds – those which heavily invest in the high-yield market.

Now, I am not suggesting that we transpose the national market system built for equities to the debt markets. For many reasons, that would not work. But it's time for this segment of the debt market to catch up with the times and the technology.

To address the lack of price transparency in the corporate debt market, I have called on the National Association of Securities Dealers to do three things:

First, adopt rules requiring dealers to report all transactions in U.S. corporate bonds and preferred stocks to the NASD and to develop systems to receive and redistribute transaction prices on an immediate basis;

Second, create a database of transactions in corporate bonds and preferred stocks. This will enable regulators to take a proactive role in supervising the corporate debt market, rather than only reacting to complaints brought by investors; and

Third, in conjunction with the development of a database, create a surveillance program to better detect fraud in order to foster investor confidence in the fairness of these markets.

I am pleased to report to you that the NASD is moving forward on all of these recommendations. This is an important step. These actions will likely result in a higher level of price transparency for the corporate debt market than what currently exists in municipal securities. And, with the strong improvements the municipal markets have undertaken recently, this is no small accomplishment. I hope that, in the near future, corporate securities will no longer be lagging, but rather leading in the pursuit of greater price disclosure.

Additional Findings

As I stated at the outset, we believe that, overall, the bond market is functioning effectively. We did, however, find certain sales practices which I find troubling.

The bond market touches all aspects of our lives – from the cost of building schools and hospitals to corporate investment in areas such as plants and equipment. It impacts the assets of public and private pension funds. It channels capital to mortgage and car loans. It even influences revolving credit.

This market also affects the prices in the equity market that everyone follows so closely. If you cannot value a company's debt accurately, it is difficult to determine the baseline value of its equity.

The bond market's economic significance is matched only by its sheer size. While New York Stock Exchange equity trading amounts to \$28 billion per day, trading volume in all bond markets totals roughly \$350 billion per day. U.S. corporate bonds outstanding have more than quadrupled since 1980. Municipal bonds have experienced similar growth. The total value of the bond market today is over \$10 trillion – up approximately 400 percent since 1980. Some tend to think of the financial market solely as an equity market. These numbers should correct that impression.

Review of the Bond Market

Our initial review of debt securities found that, as a whole, the market for government securities is characterized by high-quality pricing information for investors. We are also confident that, because of steps taken over the last few years, transparency is much greater in the municipal securities market. But, we believe that in the area of corporate bonds, price transparency is simply not up to par.

Historically, the debt markets have lagged well behind the equity markets in making price information available to investors and the public. There are good reasons for this: the debt market covers a much wider variety of instruments and is largely institutional. Nonetheless, the Commission, on several occasions, has acted to encourage debt market transparency.

In 1991 – with encouragement from the Commission and Congress, GovPX – a 24-hour, world-wide electronic reporting system – was formed to distribute real time quotes and transaction prices for U.S. Treasury and other government securities. As a result, these markets now enjoy a higher level of quality price information.

In 1995, again with the SEC's active encouragement, the Municipal Securities Rulemaking Board began collecting the details of dealer-to-dealer transactions in the municipal bond market and distributing daily summary reports. And, just last month, with SEC approval, the MSRB expanded its daily reporting to include customer trades as well as inter-dealer trades.

Now, for the first time, investors, particularly smaller investors, have access to the prices and volume data of municipal bond trading between dealers and their customers. And, our effort is not stopping there. I expect that these actions will culminate in immediate transaction price reporting – making the municipal bond market as transparent as it can possibly be.

It's now time for the corporate bond market to step up to the plate. The need has never been more evident. These days, bond dealers do not need

History of U.S. Bond Market

There seems to be a common misconception that the bond market is somehow less important than the equity market. But history shows, if anything, that the opposite may be true. The bond market has played an important role in this country's development from the very first days of the republic. The New York Stock Exchange, in fact, originated in 1792 as a bond exchange. For the first time, securities issued by the new United States government could be readily bought and sold. Those first government bonds funded the debt of the American Revolution. Treasury Secretary Alexander Hamilton not only helped create a new money supply, but he also linked the interests of wealthy bondholders to the fate of the new country.

As American corporations formed and evolved, a market for the issuance of corporate bonds followed suit. Between 1850 and the early 1900's, railroad company bonds dominated the corporate debt market. Those bonds fostered the growth of more railroad companies than there are Starbucks in Manhattan. At the same time, an expanding number of public utilities and industrial corporations were also issuing bonds. Between 1900 and our entry into World War I, corporate debt tripled from \$6 billion to over \$19 billion – exceeding the federal debt.

Bonds in those days were sold to a great extent door-to-door – literally. It was not unusual for Wall Street bond firms to hire a salesman and send him out with a bicycle, a designated territory and a list of bonds to sell. The salesman would cycle to storekeepers, farmers and country banks in the hopes of selling at least one bond a week.

As equities came to dominate the New York Stock Exchange, the vast majority of bond issues – whether Treasury bonds or corporate bonds – moved to trading on the over-the-counter market. For most of the 20th century, bonds were considered, in the words of one writer, "the staid province of high-quality borrowers...and highly conservative investors and creditors."

And, as recently as the early 1970's, most bond holders were still clipping interest coupons – mailing them in to be redeemed. Simply put, bonds were bought and held. This, in part, reflected the slow movement of long-term interest rates. "Debt money," as Edmund Burke summarized in the 18th century, "is static." For a good part of this century in this country, Burke's statement rang true.

Recent Characteristics of the Bond Market

However, with the onset of inflation in the mid-1970's, deficit spending in the 1980's and the proliferation of technology in the 1990's, the debt market fundamentally changed in practice and in scope.

Long gone are the days of bond sellers on bicycles. Global electronic markets, computer-based analytical services and rapid fluctuations in bond prices are the order of the day. It's now a fast-moving medium that plays a major role in America's economy.

In recent weeks, that has come into question. We've watched in awe as the perennial see-saw between bulls and bears has fallen and risen dramatically. And yet, despite the uncertainty we've witnessed, confidence remains strong.

Confidence doesn't make markets rise and it doesn't make markets fall. It makes markets possible. Without it, there would be neither buying nor selling. There would be silence.

Someone once noted that "Confidence awakens confidence." It is the underlying reason why America's capital markets are as strong as they are today. Transparency, disclosure and accountability aren't just catchwords. They are the essential ingredients to confidence. And without it, markets can neither sustain long-term growth nor adapt to a rapidly changing environment.

In the current financial situations in Asia and Russia, the word transparency has been employed rather frequently. Transparency is critically important in a number of ways. For instance, it's an issue in how publicly a government considers policies, or how a company's revenue is derived and what its true expenditures are, or how a bank's loan portfolio is constituted.

For securities markets, transparency is the extent to which timely data on prices are visible and understandable to all participants. At various times, some market participants have resisted efforts to increase the availability of information to investors. But experience has proven, again and again, that transparency – to borrow from President Kennedy – is a tide that lifts all boats.

Earlier this year, the SEC began reviewing the market for debt securities in the United States – with a particular emphasis on the state of price transparency. This morning, I want to report to you the staff's preliminary findings. I also want to discuss what steps I believe should be taken to help ensure that all sectors of the bond market are functioning as fairly and efficiently as possible.

Today, anyone who buys a car, or a house, or even a piece of fruit can obtain prices on identical or comparable items to guide their decision. But in certain parts of the bond market you need a research department and a trading department to discover such information. How many individual investors do you know who can afford those resources?

The sad truth is that investors in the corporate bond market do not enjoy the same access to information as a car buyer or a homebuyer or, dare I say, a fruit buyer. And that's unacceptable. Guesswork can never be a substitute for readily available price data.

So today, I am calling for increased price transparency in the corporate debt market. We are doing so for one simple reason: investors have a right to know the prices at which bonds are being bought and sold. Transparency will help investors make better decisions, and it will increase confidence in the fairness of the markets. Simply put, it's in everybody's interests.

capital markets.

Cicero once wrote that "Nothing so cements and holds together all the parts of a society as faith or credit." But faith and credit are not just simply arrived at through terms on a piece of paper. They are painstakingly forged over years in the day in and day out practices of a society.

The American experience proves that public disclosure is not a theoretical concept but a living principle. Everyday practices – whether in government, the media, academia or finance – when examined through the public lens, attain a measure of veracity and probity that would not exist if consummated under the veil of darkness.

Transparency is both a means and an end. It plays a fundamental role in making our capital markets the most efficient, liquid and resilient in the world. And, at the same time, transparency is a goal. We know from our own past experience and from the current situation in Asia and Russia that there is a direct relationship between information and investor confidence: Increase one and you increase the other; decrease one and you decrease the other. This is not rocket science. The choice is clear.

If we continue to be vigilant in the dissemination of market information to all investors, our nation's markets will remain the envy of the world. You can be sure the SEC will do its part. I expect ***all*** our markets to do theirs.

Thank you.

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