

Act and all materials required by section 14(a) or 14(c) of the Exchange Act (15 U.S.C. 78n(a) or 78n(c)) required to be filed during the 12 months immediately before filing a registration statement on this form (or for such shorter period that the registrant was required to file such reports and materials); and

(iii) Has filed on a timely basis all reports required by section 13(a) or 15(d) of the Exchange Act during the 12 calendar months and any portion of a month immediately preceding the filing of the registration statement (or for such shorter period that the registrant was required to file such reports). If during that time the registrant has used § 240.12b-25 of this chapter with respect to a report or a part of a report, that material must have been filed within the time prescribed by that section.

(2) If the registrant is an entity formed by the merger between:

(i) An entity subject to the Exchange Act reporting requirements that had only nominal assets at the time of the merger; and

(ii) An entity that was not subject to the Exchange Act reporting requirements at the time of the merger, the registrant may not file a registration statement on this form until it has filed an annual report on Form 10-K or Form 10-KSB (§ 249.310 or § 249.310b of this chapter) containing audited financial statements for a fiscal year ending after consummation of the merger.

(b) A registrant may use this form for registration under the Act of the following securities:

\* \* \* \* \*

3. By amending Form S-8 (referenced in § 239.16b) in General Instruction A to redesignate paragraphs 1.(a) and 1.(b) as paragraphs 1.(d) and 1.(e); revise the introductory text of paragraph 1.; and add new paragraphs 1.(a) and 1.(b) to read as follows:

**Note:** The text of Form S-8 does not, and this amendment will not, appear in the Code of Federal Regulations.

#### **Form S-8 Registration Statement Under the Securities Act of 1933**

\* \* \* \* \*

#### **General Instructions**

##### **A. Rule as to Use of Form S-8**

1. A registrant may use this form for registration under the Securities Act of 1933 of the securities listed in paragraph 1.(d) and 1.(e) of this section if the registrant satisfies the requirements of paragraph 1.(a) and 1.(b) of this section:

(a) A registrant may not file a registration statement on this form

unless, immediately before filing the registration statement, the registrant:

(i) Is subject to the reporting requirements of Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") (15 U.S.C. 78m(a) or 78o(d));

(ii) Has filed all reports required by Section 13(a) or 15(d) of the Exchange Act and all materials required by Section 14(a) or 14(c) of the Exchange Act (15 U.S.C. 78n(a) or 78n(c)) required to be filed during the 12 months immediately before filing a registration statement on this form (or for such shorter period that the registrant was required to file such reports and materials); and

(iii) Has filed on a timely basis all reports required by Section 13(a) or 15(d) of the Exchange Act during the 12 calendar months and any portion of a month immediately preceding the filing of the registration statement (or for such shorter period that the registrant was required to file such reports). If during that time the registrant has used Rule 12b-25 (§ 240.12b-25 of this chapter) under the Exchange Act with respect to a report or a part of a report, that material must have been filed within the time prescribed by that rule.

(b) If the registrant is an entity formed by the merger between:

(i) An entity subject to the Exchange Act reporting requirements that had only nominal assets at the time of the merger; and

(ii) An entity that was not subject to the Exchange Act reporting requirements at the time of the merger, the registrant may not file a registration statement on this form until it has filed an annual report on Form 10-K or Form 10-KSB (§ 249.310 or § 249.310b of this chapter) containing audited financial statements for a fiscal year ending after consummation of the merger.

\* \* \* \* \*

Dated: February 25, 1999.

By the Commission.

**Margaret H. McFarland,**

*Deputy Secretary.*

[FR Doc. 99-5298 Filed 3-5-99; 8:45 am]

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## **SECURITIES AND EXCHANGE COMMISSION**

### **17 CFR Part 240**

**Release No. 34-41110; File No. S7-5-99**

**RIN 3235-AH40**

#### **Publication or Submission of Quotations Without Specified Information**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Reproposed rule.

**SUMMARY:** The Securities and Exchange Commission is reproposing for comment amendments to Rule 15c2-11 under the Securities Exchange Act of 1934 (Exchange Act). Rule 15c2-11 governs the publication of quotations for securities in a quotation medium other than a national securities exchange or Nasdaq. Also, we are reproposing a companion amendment to relocate in Rule 17a-4 under the Exchange Act the record retention requirement currently contained in Rule 15c2-11. The original proposal was issued in February 1998 in response to concerns about increased incidents of fraud and manipulation in over-the-counter (OTC) securities, which typically involve thinly-traded securities of thinly-capitalized issuers (i.e., microcap securities).

The reproposed amendments are more limited than the initial proposal and focus the Rule on those securities the Commission believes are more likely to be prone to fraud and manipulation. The reproposal is part of the Commission's continuing efforts in regulatory, inspections, enforcement, and investor education areas that are key to deterring microcap fraud.

In addition, the reproposal will increase the information that broker-dealers must review before publishing quotations for non-reporting issuers' securities, and will ease the Rule's recordkeeping requirements when broker-dealers have electronic access to information about reporting issuers. Finally, we are giving guidance to broker-dealers on the scope of the review required by the Rule and providing examples of "red flags" that they should look for when reviewing issuer information.

**DATES:** Comments must be received on or before April 7, 1999.

**ADDRESSES:** Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Mail Stop 6-9, Washington, DC 20549. Comments may also be submitted

electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-5-99. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Electronically submitted comment letters will be posted on the Commission's Internet website (<http://www.sec.gov>).

**FOR FURTHER INFORMATION CONTACT:** Any of the following attorneys in the Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW, Mail Stop 10-1, Washington, DC 20549, at (202) 942-0772: Nancy J. Sanow, Irene A. Halpin, Florence E. Harmon, Chester A. McPherson, or Jerome J. Roche.

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**I. Executive Summary**

*A. Overview of the Microcap Fraud Problem and Efforts to Prevent Further Abuses*

Because incidents of fraud and manipulation involving microcap securities are a serious concern, the Commission, along with other regulators, has made combating microcap fraud one of its top priorities. Microcap securities generally are characterized by low share prices and little or no analyst coverage.<sup>1</sup> The issuers of microcap securities typically are thinly-capitalized and information about them often is limited, particularly when they are not subject to the Commission's periodic disclosure requirements. Securities of microcap companies usually are quoted on the OTC Bulletin Board operated by the National Association of Securities Dealers, Inc. (NASD), or in the Pink Sheets published by the National Quotation Bureau, Inc. (NQB), but they are not exclusive to these quotation mediums.<sup>2</sup>

Microcap fraud often involves schemes such as "pump and dump" operations, in which unscrupulous brokers sell the securities of less-seasoned issuers to retail customers by

using high pressure sales tactics and a supply of securities under the firm's control. The fraudsters create interest in the security by disseminating false or misleading information about the issuer through, for example, oral statements, press releases, or the Internet. To further the manipulative scheme, the retail broker frequently acts as a market maker in the security or, either on its own or through the issuer's promoter, induces other firms to act as market makers.

By publishing quotations, the market maker raises the profile of the security, even though the market maker is not an active participant in the fraud and publishes quotations solely in response to increased demand for the security. The broker, promoter, or others orchestrating the fraud can point to quotations for the security to "validate" its worth. The perpetrators of the fraud then dispose of their stake at an inflated price. Once they no longer need to stimulate interest in the security, the market for it collapses and innocent investors are left holding stock with little or no value.

The defrauded victims of microcap fraud activities are not the only ones harmed. When other investors become reluctant or unwilling to invest in the kinds of securities they perceive as prone to fraud, liquidity for those securities can be impaired. As a result, existing shareholders can face difficulty in disposing of their holdings and legitimate issuers of lower-priced stocks can find it hard to raise capital to start up or expand operations or services. In short, continuing incidents of microcap fraud are detrimental to the integrity of our nation's capital markets.

To combat microcap abuses, we have initiated several enforcement, examination, education, and regulatory measures. These actions include the following:

- In September 1998, we filed 13 enforcement actions against 41 defendants for their involvement in fraudulent microcap schemes that bilked investors of more than \$25 million.<sup>3</sup>

- We conducted a nationwide sweep to combat fraud through the Internet, which resulted in 23 enforcement actions against 44 stock promoters of microcap stocks in October 1998.<sup>4</sup>

<sup>1</sup> The term *microcap securities* is not defined under the federal securities laws or regulations. The use of the term "microcap securities" in this release, however, should be distinguished from its use in the mutual fund context. For example, Lipper Analytical Services, a mutual fund rating organization, generally categorizes microcap companies as companies with market capitalization of less than \$300 million. Lipper-Directors' Analytical Data, Investment Objective Key, 2d ed. 1997.

<sup>2</sup> Microcap securities can also be listed on securities exchanges or Nasdaq or quoted in alternative trading systems.

<sup>3</sup> For a summary of these cases, see *Fight Against Microcap Fraud "Paying Dividends"*, Press Release No. 98-92 (September 24, 1998), available through our Internet website at <<http://www.sec.gov/news/micronew.htm>>.

<sup>4</sup> For a summary of these cases, see *Purveyors of Fraudulent Spam, Online Newsletters, Message Board Postings, and Websites Caught*, Press Release No. 98-117 (October 28, 1998), available through

- We initiated examination sweeps of several firms that are active in the microcap market. Our examination staff conducted complex and resource-intensive reviews of these firms' records for evidence of the hallmarks of microcap fraud, such as patterns of "bait and switch" sales techniques, misrepresentations and exaggerated claims, unauthorized trading and refusals to sell securities, market manipulation, and lax or nonexistent supervision.

- We have held numerous investors' town meetings across the country to educate people about investing wisely, and we have put together several brochures to assist investors.<sup>5</sup>

- We are cooperating with self-regulatory organizations (SROs) to improve supervision and regulation of the OTC securities market. For example, we recently approved NASD rule changes that limit quotations on the OTC Bulletin Board to the securities of issuers that are current in their reports filed with the Commission or other regulatory authority.<sup>6</sup>

- We have taken steps to strengthen our regulations and close loopholes to help reduce incidents of microcap fraud.

Today, we are taking action on several additional regulatory measures aimed at preventing further incidents of microcap fraud. In addition to adopting amendments to Form S-8<sup>7</sup> under the Securities Act of 1933 (Securities Act)<sup>8</sup> and adopting amendments to Regulation D,<sup>9</sup> we are reproposing amendments to Rule 15c2-11<sup>10</sup> under the Securities Exchange Act of 1934 (Exchange Act),<sup>11</sup>

our Internet website at <<http://www.sec.gov/news/netfraud.htm>>.

<sup>5</sup> See, e.g., "Microcap Stock: A Guide for Investors" (providing a variety of tips on how to detect and avoid microcap fraud); "Cold Calling Alert" (describing the cold calling rules and instructing investors how to avoid telephone scams); "Internet Fraud" (describing common frauds including on-line newsletter and bulletin board posting scams); and "Ask Questions" (listing questions that investors should ask about their investments and their investment professionals). All of these publications are available for free from our toll-free publications line at (800) 732-0330 and can be downloaded through our Internet website at <<http://www.sec.gov>>.

<sup>6</sup> Securities Exchange Act Release No. 40878 (January 4, 1999), 64 FR 1255 (OTC Bulletin Board Release).

<sup>7</sup> Securities Act Release No. 33-7646 (February 19, 1999). The amendments to Form S-8 restrict the use of Form S-8 for the sale of securities to consultants and advisors, among other things.

<sup>8</sup> 15 U.S.C. 77a *et seq.*

<sup>9</sup> Securities Act Release No. 33-7644 (February 19, 1999). The amendments limit the circumstances where freely tradable securities may be issued in reliance on, and general solicitation is permitted under, Rule 504 of Regulation D.

<sup>10</sup> 17 CFR 240.15c2-11.

<sup>11</sup> 15 U.S.C. 78a *et seq.*

our rule that governs the quotations by broker-dealers for OTC securities.<sup>12</sup> Rule 15c2-11 is intended to prevent broker-dealers from becoming involved in the fraudulent manipulation of OTC securities. However, even if a broker-dealer technically complies with the Rule's requirements, it would be subject to liability under other antifraud provisions of the securities laws, such as Rule 10b-5, if it publishes quotations as part of a fraudulent or manipulative scheme.<sup>13</sup>

#### *B. Background of Rule 15c2-11 and Recent Proposed Amendments*

Rule 15c2-11 contains requirements that are intended to deter broker-dealers from initiating or resuming quotations for covered OTC securities that may facilitate a fraudulent or manipulative scheme. The Rule currently prohibits a broker-dealer from publishing (or submitting for publication) a quotation for a covered OTC security in a quotation medium unless it has obtained and reviewed current information about the issuer.<sup>14</sup> The broker-dealer must also have a reasonable basis for believing that the issuer information, when considered along with any supplemental information, is accurate and is from a reliable source.<sup>15</sup>

The Rule currently contains several exceptions to its prohibitions. Under the "piggyback" exception, the Rule's information requirements do not apply when a broker-dealer publishes, in an interdealer quotation system, a quotation for a covered OTC security that was already the subject of regular and frequent quotations in the same interdealer quotation system.<sup>16</sup> A

<sup>12</sup> In this release, "OTC stocks" or *OTC securities* refers to securities that are not listed on a national securities exchange or Nasdaq. "Covered OTC securities" refers to those OTC securities that are subject to Rule 15c2-11. The Rule applies to securities quoted on the OTC Bulletin Board operated by the NASD, the Pink Sheets operated by the NQB, and similar quotation mediums. For further discussion of quotation mediums, see Part III.F. below.

<sup>13</sup> 17 CFR 240.10b-5.

<sup>14</sup> Rule 15c2-11 defines *quotation* as any bid or offer at a specified price with respect to a security, or any indication of interest by a broker or dealer in receiving bids or offers from others for a security, or any indication by a broker or dealer that advertises its general interest in buying or selling a particular security. For the purposes of this release, a "priced quotation" is a bid or offer at a specified price.

<sup>15</sup> See Part III.C. below for a description of the required issuer and supplemental information.

<sup>16</sup> An *interdealer quotation system* is a quotation medium of general circulation to brokers or dealers which regularly disseminates quotations of identified brokers or dealers. 17 CFR 240.15c2-11(e)(2). Under the proposed amendments, the definition of "interdealer quotation system" would be incorporated into the definition of "quotation

broker-dealer is able to "piggyback" on either its own or other broker-dealers' previously published quotations. This exception assumes that regular and frequent quotations for a security generally reflect market supply and demand and are based on independent, informed pricing decisions. However, as a result of the piggyback provision, the Rule's application is essentially limited to just the first broker-dealer publishing quotes.

In February 1998, the Commission published for comment amendments to the Rule that were designed to curb fraud in microcap securities.<sup>17</sup> This proposal would have eliminated the piggyback provision by requiring all broker-dealers to review current issuer information before publishing their first quotation for a covered OTC security, without regard to whether the quotation was priced or unpriced, and to thereafter review current issuer information annually if they published priced quotations. With limited exceptions, the proposal would have applied to any security quoted in a quotation medium other than a national securities exchange or Nasdaq. The proposal would also have expanded the information required for issuers that do not file periodic reports with the Commission (e.g., non-reporting issuers). In addition, broker-dealers would have been required to make the issuer information available to anyone who requested it.

In response to the Proposing Release, we received 199 comment letters from 193 commenters.<sup>18</sup> The majority of commenters, which included broker-dealers, issuers, attorneys, and individuals, opposed many of the proposed changes. Broker-dealers were especially concerned that they would be exposed to potential liability in civil actions as a result of their increased review obligations under the proposal. Commenters also expressed views about the possibility of: reduced liquidity in covered OTC securities if broker-dealers stopped making markets; less transparent markets if broker-dealers did not publish priced quotes to avoid the annual review requirement; less competitive pricing for covered OTC securities; impaired access to capital by

medium." See Part III.F. below for a discussion of the term "quotation medium."

<sup>17</sup> Securities Exchange Act Release No. 39670 (February 17, 1998), 63 FR 9661 (Proposing Release).

<sup>18</sup> This total includes virtually identical comment letters from 68 issuers. All comment letters are available in File No. S7-3-98 at our Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Comment letters that were submitted electronically are available through our Internet website at <<http://www.sec.gov/rules/s7398.htm>>.

issuers; and increased compliance costs for broker-dealers. In addition, some commenters pointed out that the proposal would not cover Nasdaq SmallCap securities, which, they noted, have also been the subject of abusive activities. Some commenters also remarked that the proposal would not stop microcap fraud, which, in their view, is really a sales abuse problem.

Several commenters, principally state securities regulators and their national association, supported the proposal. They believed that microcap fraud would be deterred if broker-dealers are required to review issuer information and make their own independent and substantiated determinations before publishing quotations. Further, commenters favoring the proposal stated that the availability of information via EDGAR and the speed of communication via the Internet would ease any increased burden on broker-dealers created by the Rule amendments. Finally, a number of commenters were more neutral in their approach and offered views or suggestions on specific provisions.

## II. Overview of Reproposed Amendments

The Commission is issuing a revised proposal to amend Rule 15c2-11 to help curtail abuses in the offer, sale and trading of microcap securities. Because these amendments will significantly change the Rule's scope, we are publishing them to give interested persons an opportunity to provide us with their comments and views.

The amendments are intended to have broker-dealers "stop, look and listen" before they begin to quote a covered OTC security in a quotation medium other than a national securities exchange or Nasdaq. However, the amendments reflect commenters' concerns about the earlier proposal by limiting the scope of the Rule principally to priced quotations and to those securities that the Commission believes are more likely to be the subject of improper activities. Under these amendments, the Rule will no longer apply to securities of larger issuers, or to securities that have a substantial trading price or that meet a minimum dollar value of average daily trading volume. In addition, the Rule will only cover priced quotations, except in the case of the first quotation for a covered OTC security. The provisions relating to the broker-dealer's obligations under the Rule and the issuer information that the broker-dealer must review are little changed from the initial proposal.

We also are providing guidance regarding the steps broker-dealers

should take and "red flags" they should consider when reviewing the Rule's required information. In response to commenters' concerns about broker-dealer liability, we stress that broker-dealers will have no obligation to continuously update their Rule 15c2-11 materials. The broker-dealer's review obligations under the Rule occur only at the specific times identified in the Rule.

In general, the amendments would:

- Limit the Rule primarily to priced quotations;<sup>19</sup>
- Eliminate the Rule's piggyback provision and require all broker-dealers to review current issuer information before publishing priced quotations for a security;
- Require broker-dealers publishing priced quotations for a security to review current information about the issuer annually and upon the occurrence of specified events;
- Expand the information required for certain non-reporting issuers;
- Require documentation of the broker-dealer's compliance with the Rule; and
- Require broker-dealers publishing quotes in compliance with the Rule to provide the issuer information upon request to customers, prospective customers, information repositories, and other broker-dealers.

In addition, the amendments would exclude from the Rule's coverage:

- Securities with a worldwide average daily trading volume value of at least \$100,000 during each month of the six full calendar months immediately preceding the date of publication of a quotation, and convertible securities where the underlying security satisfies this threshold;
- Securities with a bid price of at least \$50 per share;
- Securities of issuers with net tangible assets in excess of \$10,000,000, as demonstrated by audited financial statements;
- Non-convertible debt and non-participatory preferred stock; and
- Asset-backed securities that are rated as investment grade by at least one nationally recognized statistical rating organization.

These amendments are intended to enhance the integrity of quotations for securities in this market sector, to improve the quality of information about smaller, lesser-known issuers, and to foster greater access to this information by investors. The

amendments also reorganize and simplify the Rule's provisions consistent with the Commission's Plain English program.

## III. Discussion of Amendments

The amendments restructure Rule 15c2-11 by setting forth more clearly the quotation events that trigger the Rule, the requirements that the broker-dealer must satisfy, and the nature of the information that the broker-dealer must review. The amendments state that no broker-dealer, directly or indirectly, may publish the described kinds of quotations for a security in any quotation medium, without first complying with the Rule's provisions. The Rule will only apply at specified points in time, namely, when a broker-dealer publishes:

- The first quotation for a security;
- Its first quotation at a specified price for a security after another broker or dealer published the first quotation for the same security;
- The first quotation following the termination of a Commission trading suspension ordered pursuant to section 12(k) of the Exchange Act<sup>20</sup> in any security of the issuer of the suspended security;
- A quotation at a specified price for a security after a period of five or more consecutive business days when it did not publish any quotations at a specified price for that security;
- Its first quotation at a specified price for a security after the date that is four months after the end of the issuer's fiscal year, unless the issuer is a foreign private issuer; or
- Its first quotation at a specified price for a security of a foreign private issuer after the date that is seven months after the end of the issuer's fiscal year.

The broker-dealer's information gathering and review requirements are substantially the same as the initial proposal.<sup>21</sup> If the Rule applies, the broker-dealer must:

- Review the Rule's specified information;
- Determine that it has a reasonable basis for believing that the information is accurate in all material respects and was obtained from reliable sources;
- Record the date it reviewed the specified information, the sources of the information, and the person at the firm responsible for the broker-dealer's compliance with the Rule; and

<sup>20</sup> 15 U.S.C. 781(k).

<sup>19</sup> The amendments, however, will prohibit the first broker-dealer from publishing a priced or unpriced quotation for a covered OTC security unless it complies with the Rule. For a discussion of the requirements concerning the initial quotation for a covered OTC security, see Part III.B.1. below.

<sup>21</sup> However, we are narrowing the scope of the requirement contained in the Proposing Release that broker-dealers provide the Rule 15c2-11 information to others upon their request. See Part II.D. below.

- Preserve the specified information in accordance with Rule 17a-4.<sup>22</sup>

Commenters on the Proposing Release did not object to the standards set forth in these review and documentation requirements. Rather, they expressed concerns about the scope of a broker-dealer's review obligations under the earlier proposal, particularly as some of them misconstrued the proposal to require continuous updating of information. To assist broker-dealers publishing quotations for covered OTC securities, we are giving guidance in an appendix to this release about the nature of the review we expect broker-dealers to conduct under both the current Rule and the proposed amendments.

#### A. Securities Excluded From the Rule

Several commenters suggested that the Rule should cover only those securities that have the characteristics that have led to abuses in the microcap market.<sup>23</sup> These commenters noted that, while the earlier proposal was intended to focus on microcap abuses, it covered quotations for a number of non-reporting foreign and domestic issuers' securities that are unlikely to be the targets of microcap schemes. They suggested that the amendments be crafted to cover only those equity securities most likely to be prone to abusive activities.

We agree that applying the Rule to the securities of larger issuers, more liquid securities, and certain fixed-income debt securities is not directly related to microcap fraud concerns.<sup>24</sup> We therefore are proposing to exclude from Rule 15c2-11 those securities satisfying any one of three alternative tests based on: the value of the security's average daily trading volume (ADTV); the security's bid price; or the issuer's net tangible assets.<sup>25</sup> We are also proposing to exclude debt securities, non-participatory preferred stock, and investment grade asset-backed securities.

#### 1. Securities Satisfying a Trading Value Test

To tailor the Rule to transactions that we believe are most likely to involve microcap fraud, the amendments exclude securities with a value of worldwide ADTV of at least \$100,000 during each month of the six full calendar months immediately preceding the date of publication of a quotation.<sup>26</sup> Convertible securities will also be excluded when the underlying security satisfies this threshold.

The majority of OTC stocks of U.S. companies that are not listed on an exchange or Nasdaq trade infrequently and will not satisfy for a test based on a value of ADTV of \$100,000 or more during each month over a six month measuring period. However, there are a number of non-reporting issuers having securities with significant trading levels, particularly larger foreign issuers with actively traded securities in their home markets. We think that it is appropriate to take this trading activity into account in applying the value of ADTV test.

The price of a microcap security that is the subject of a fraud often is manipulated upward rapidly so that those involved in the manipulation can quickly sell stock at a significant profit, to the detriment of innocent investors. Microcap securities involved in such manipulations often are thinly traded, and the daily trading volume for such securities rarely reaches a value of \$100,000 over an extended period of time. We believe that measuring the value of the security's ADTV over a six month period is a way to ensure that the securities qualifying for this exclusion are not involved in the type of short-term price manipulations frequently seen in microcap schemes.

A broker-dealer should determine the value of a security's ADTV from information that is publicly available and that the broker-dealer has a reasonable basis for believing that the information is reliable.<sup>27</sup> In calculating the value of ADTV in U.S. dollars, any

reasonable and verifiable method may be used.<sup>28</sup> For example, it may be derived from multiplying the number of shares by the price in each trade. The NASD may also be able to assist broker-dealers in determining whether a particular security is eligible for the exclusion.

Q1. Should the dollar value of ADTV for this exclusion be higher than \$100,000, e.g., \$500,000 or \$1 million, or should it be a lower amount, e.g., \$50,000? Commenters should provide data and analysis to support suggested revisions to this proposed threshold.

Q2. Should the dollar value of ADTV measuring period be longer than six months, e.g., twelve months, or be shorter, e.g., three months? Should the length of the measuring period depend on the amount of the value of ADTV threshold, i.e., should a lower value of ADTV threshold be allowed but require a longer measuring period?

Q3. Should the exclusion based on ADTV value also incorporate a value of public float test, like Regulation M does? If so, should the public float value be \$25 million or some higher or lower amount? Would public float information be easy or difficult to obtain for non-reporting issuers?<sup>29</sup>

Q4. Rule 101 under the Commission's Regulation M excludes from that rule's trading prohibitions securities with a value of ADTV of \$1 million or more, using a two month measuring period, if the issuer has a public float value of at least \$150 million. Should Rule 15c2-11's exclusion parallel the terms of this exclusion?

#### 2. Securities Satisfying a Bid Price Test

To limit the Rule to transactions that the Commission believes are most likely to involve microcap fraud, we are proposing an amendment to exclude securities with a bid price of at least \$50 per share at the time the quotation is published in the quotation medium.<sup>30</sup> While the vast majority of OTC stocks are quoted at lower prices and will not typically satisfy for a test based on a bid price of at least \$50 per share, there are

<sup>22</sup> 17 CFR 240.17a-4.

<sup>23</sup> See, e.g., Letter from Securities Industry Association (April 28, 1998) (SIA Comment Letter).

<sup>24</sup> Of course the general antifraud provisions of the federal securities laws, including Rule 10b-5 (17 CFR 240.10b-5), apply to transactions in all securities, whether or not excluded from Rule 15c2-11.

<sup>25</sup> We estimate that at least 10% of covered OTC securities will be excluded from the Rule under these tests. We estimate that approximately 5% of the OTC securities of U.S. companies, 10% of the OTC securities of foreign issuers (excluding ADRs), and 66% of OTC American Depositary Receipts (ADRs) will satisfy any one of these three alternative tests.

<sup>26</sup> We have used an ADTV value of \$100,000 in another, but related, context. Rules 101 and 102 of Regulation M, 17 CFR 242.101 and 102, provide for a one business day restricted period for securities with an ADTV value of at least \$100,000 (as measured over a 60 day period), if the issuer has a public float value of at least \$25 million. These rules are intended to prevent manipulative activities during a distribution.

<sup>27</sup> A broker-dealer will be able to rely on trading volume as reported by SROs or comparable entities, or any other source believed to be reliable. Electronic information systems that provide information regarding securities in markets around the world could provide an easy means to determine worldwide trading volume in a particular security. Worldwide trading volume includes all markets, domestic or foreign, where an OTC security is traded.

<sup>28</sup> This is comparable to the calculation of value of ADTV under Regulation M. See Securities Exchange Act Release No. 38067 (December 20, 1996), 62 FR 520, 537.

<sup>29</sup> See *id.*

<sup>30</sup> Most of the Commission's recent trading suspension orders issued under Section 12(k) of the Exchange Act, 15 U.S.C. 781(k), have involved securities quoted on the OTC Bulletin Board or the Pink Sheets. Our staff's analysis of these trading suspension orders, issued between April 1, 1994 and January 1, 1998, showed that the suspended OTC securities had an average bid price of approximately \$5, with a median bid price of approximately \$3. These securities had bid prices that ranged from a low of approximately \$0.50 to a high of approximately \$18.

securities of closely-held issuers that are quoted at significant share prices. The broker-dealer publishing the quotation can use its own *bona fide* quotation to satisfy the test. The broker-dealer cannot use its own or another broker-dealer's unpriced quotation to rely on this test, even if the broker-dealer publishing a name-only quotation provides a bid price of at least \$50 per share upon inquiry. If a security is a unit composed of one or more securities, the bid price of the unit, when divided by the number of shares of the unit that are not warrants, options, rights, or similar securities, must be at least \$50 to be excepted from the Rule.<sup>31</sup>

Q5. Should this exclusion be based on a bid price higher than \$50 per share, e.g., \$100 per share or lower, e.g., \$20 per share? Commenters should provide data and analysis to support suggested alternatives to the proposed threshold.

Q6. Should this exclusion be available only if the security has a bid price of \$50 over a specified period of time?

Q7. Should this test be based instead on the security's last sale price? If so, should there be a time limit added to such a test so that a stale last sale price cannot be used?

### 3. Securities of Issuers Satisfying a Net Tangible Assets Test

Microcap fraud schemes generally involve issuers with limited assets.<sup>32</sup> We are therefore proposing to exclude securities of issuers having net tangible assets in excess of \$10,000,000, as determined by audited financial statements.

If the issuer is not a foreign private issuer, a broker-dealer should make this determination using the most recent financial statements for the issuer that have been audited and reported on by an independent public accountant in accordance with the provisions of Rule 2-02 of Regulation S-X.<sup>33</sup> If the issuer is a foreign private issuer, a broker-dealer should make this determination using the most recent financial statements for the issuer (dated less than 18 months prior to the date of the publication of the quotation) that are prepared in accordance with a comprehensive body of accounting principles, audited in compliance with requirements of the country of

incorporation, and reported on by an accountant duly registered and in good standing under the regulations of that jurisdiction.<sup>34</sup> If audited financial statements are unavailable, the broker-dealer may not rely on this exception.

Some commenters suggested that we look to the current definition of "penny stock" in assessing the scope of Rule 15c2-11. Exchange Act Rule 3a51-1 excludes from the definition of penny stock a security of an issuer having net tangible assets in excess of \$2 million, if the issuer has been in continuous operation for at least 3 years, or \$5 million, if the issuer has been in continuous operation for less than three years.<sup>35</sup> We preliminarily believe that, for purposes of an exclusion from the Rule, the net tangible assets amount should be higher, and, unlike the definition of penny stock, the threshold need not distinguish between newer and more seasoned issuers.

Q8. Should the threshold amount for this net tangible assets test be higher than \$10 million, e.g., \$20 million? Under what circumstances would it be appropriate to permit a lower threshold amount? Commenters should provide data and analysis to support their views on whether the threshold amount should be raised or lowered.

Q9. For ease of compliance with both Commission and NASD rules, should this exclusion parallel the exclusion contained in the NASD's proposed rule that would require broker-dealers to review current information about the issuer of an OTC security before recommending a transaction in the security?<sup>36</sup> The NASD proposal would exclude the securities of issuers having total assets of at least \$100 million and shareholders' equity of at least \$10 million, based on audited financial statements.

Q10. Will there be sufficient information in financial statements, particularly those of non-reporting issuers, to permit broker-dealers to make the net tangible assets calculation?

Q11. Should the use of financial statements of a foreign private issuer be limited to financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP)?

Q12. Should the use of financial statements of a foreign private that are not prepared in accordance with U.S. GAAP be limited to financial statements prepared in accordance with the accounting standards promulgated by the International Accounting Standards Committee (IASC)?<sup>37</sup>

Commenters are invited to provide us with their views on the alternative tests for an exclusion from Rule 15c2-11, as described above.

Q13. Should all three of the tests based on value of ADTV, bid price, and net tangible assets be incorporated into Rule 15c2-11?

Q14. Should the proposed exclusions from the Rule be limited to those securities that satisfy at least two of the three tests?

Q15. Are there other tests that are more appropriate to exclude the securities of larger, more seasoned issuers from Rule 15c2-11? For example, should a security that has no or very minimal trading volume be excluded from the Rule's requirements? What would be an appropriate low volume threshold? If trading volume suddenly exceeded the low volume threshold, would broker-dealers publishing quotes find it easy or difficult to have to obtain and review information before continuing to publish priced quotations?

### 4. Non-Convertible Debt, Non-Participatory Preferred Stock, and Asset-Backed Securities

We are proposing to exclude non-convertible debt securities, non-participatory preferred stock,<sup>38</sup> and asset-backed securities that are rated by at least one nationally recognized statistical rating organization, as that term is used in Rule 15c3-1 under the Exchange Act,<sup>39</sup> in one of its generic rating categories that signifies investment grade.<sup>40</sup> Commenters on this

<sup>37</sup> IASC's accounting standards are summarized on, and may be ordered through, the IASC's Internet website at <<http://www.iasc.org.uk>>.

<sup>38</sup> Non-participatory preferred stock means non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer. See paragraph (j)(8) of the Rule proposal, which is based upon a definition contained in Rule 902(a)(1) of Regulations S (17 CFR 230.902(a)(1)).

<sup>39</sup> 17 CFR 240.15c3-1 (net capital requirements for broker-dealers).

<sup>40</sup> The Commission's staff is engaged in a project to consider the development of disclosure and registration requirements specifically related to asset-backed securities. As part of that project, the staff intends to examine further the role of ratings with respect to asset-backed securities. Therefore, we consider it appropriate to limit the proposed

<sup>31</sup> This is comparable to the provisions excluding equity securities priced at \$5 or more from the definition of "penny stock" contained in 17 CFR 240.3a51-1(d)(2).

<sup>32</sup> Analysis of OTC securities that were the subject of recent Commission-ordered trading suspensions showed the issuers on average had approximately \$3,500,000 in net tangible assets, with a median of approximately \$225,000 in such assets.

<sup>33</sup> 17 CFR 210.2-02.

<sup>34</sup> These financial statements may be found in filings with the Commission on Forms 20-F or 6-K, or in submissions under Rule 12g3-2(b) under the Exchange Act (17 CFR 240.12g3-2(b)), or elsewhere.

<sup>35</sup> 17 CFR 240.3a51-1.

<sup>36</sup> See proposed NASD Rule 2315, which the Commission recently issued for public comment. Securities Exchange Act Release No. 41075 (February 19, 1999). The proposed rule will be available through the NASD Regulation Internet website at <<http://www.nasdr.com>> and our Internet website at <<http://www.sec.gov>>.

issue generally supported excluding fixed-income securities from the Rule.

The fraud and manipulation that we have observed in the microcap securities have not been evident in the fixed-income market. In addition, non-convertible debt securities, non-participatory preferred stock, and investment grade asset-backed securities generally trade at prices and in denominations that make them less likely targets for manipulation. Further, the type of issuer information required by the Rule is much less relevant to the pricing and trading of these types of securities.

Q16. Should this exclusion apply to all asset-backed securities or should the exclusion apply only to asset-backed securities that are rated investment grade on the basis that those securities are even less likely to be subject to fraudulent activities?

Q17. Should the Rule exclude all non-convertible debt and non-participatory preferred stock or should the exclusion apply only to non-convertible debt and non-participatory preferred stock that are rated investment grade?

## 5. Other Exceptions

The exceptions relating to quotations for exchange-listed and Nasdaq securities, quotations representing a customer's unsolicited order, and quotations for exempted securities remain substantively the same as currently in the Rule. As we indicated in the Proposing Release, the unsolicited status of the customer orders would be called into question if a broker-dealer repeatedly publishes quotations on the basis of the unsolicited customer order exception.<sup>41</sup>

Q18. Should unsolicited customer orders be required to be identified as such in the quotation medium? Is it feasible for quotation mediums to show that the quote represents an unsolicited customer order?

## B. Quotations Subject to the Rule

### 1. The Initial Quotation for a Covered OTC Security

As indicated above, the Rule's requirements will apply at the time of discrete quotation events. Subject to the Rule's exceptions, the amendments will prohibit the first broker-dealer from publishing a priced or unpriced quotation for a covered OTC security in a quotation medium unless it has

obtained and reviewed specified information about the issuer and the security. Further, this information will need to be submitted to the NASD, in accordance with the NASD's rules, at least three business days before the quotation is published.<sup>42</sup> There is one situation that "restarts" the Rule's requirements: following the termination of a Commission trading suspension ordered pursuant to Exchange Act Section 12(k),<sup>43</sup> the broker-dealer publishing the first quote, whether it is priced or unpriced, must comply with Rule 15c2-11. In essence, this is the way the Rule currently works.

We believe that the Rule should cover the first quotation as a means to assure that there is basic information about the issuer available to the marketplace before trading in the security begins and to alert regulators that trading in the security will be starting. The NASD uses Rule 15c2-11 submissions for surveillance and enforcement purposes and routinely provides copies of this information to the Commission.

### 2. Priced Quotations

While the first broker-dealer must obtain the required information for the initial quotation (priced or unpriced) for a covered OTC security as discussed above, thereafter the Rule will only apply to broker-dealers submitting their first priced quotations. The Rule's review requirements are also triggered when a broker-dealer first publishes a priced quotation following the lapse of five or more business days of its priced quotations for the security. In addition, as discussed below, a broker-dealer must satisfy the Rule's requirements if it publishes a priced quotation as of a specific date following the end of the issuer's fiscal year.

We propose to focus the Rule's requirements after publication of the first quote on priced quotations, because recent microcap manipulation schemes have primarily involved priced quotations. In addition, priced quotes are used as indicia of value for a variety of purposes (e.g., bank loans or pledges of securities). This revision also responds to the concerns of several commenters that the earlier proposal could have resulted in some broker-dealers being precluded from publishing any quotations if they could not obtain the Rule's required information. We solicit commenters' views, however, on whether unpriced indications of interest will be used more often in unlawful

microcap activities, and, if so, whether the Rule should cover all initial quotations.

### 3. Annual Review

The amendments require a broker-dealer to review the specified information annually if the broker-dealer publishes priced quotations for the security. The date by which the annual review must be performed depends on whether the issuer is a domestic or a foreign company:

- *Domestic Issuers:* The annual review must occur prior to the first priced quotation that is more than four months after the end of the issuer's fiscal year.
- *Foreign Private Issuers:* The annual review must occur prior to the first priced quotation that is more than seven months following the end of the issuer's fiscal year.

The purpose of this requirement is to make sure that the broker-dealer periodically reviews fundamental information about the issuer if the broker-dealer continues to publish priced quotations. The broker-dealer should know if no current information about the issuer exists or if current information reflects a significant change in the issuer's ownership, operations, or financial condition.

While we originally proposed two alternative dates for conducting the annual review, to simplify the Rule we are reproposing only one date for each type of security.<sup>44</sup> Four months after the end of the issuer's fiscal year, a broker-dealer publishing priced quotes for a covered OTC security of a domestic issuer must have conducted the annual review. In the case of a foreign private issuer's security, the annual review must occur before the broker-dealer publishes a priced quote following the date that is seven months after the issuer's fiscal year end. We believe that these time periods give a broker-dealer sufficient time to obtain and review updated issuer information for both reporting and non-reporting issuers.

Some commenters opposed the annual review requirement because of potential recordkeeping burdens, the perceived difficulty of obtaining the required information, and the loss of liquidity that could potentially occur if broker-dealers could not publish priced quotes because current issuer information was unavailable.<sup>45</sup>

<sup>44</sup> The initial proposal would have permitted a broker-dealer to conduct the annual review as of the anniversary date of the initial quotation.

<sup>45</sup> See Letter from A.G. Edwards & Sons, Inc., (April 27, 1998) (A.G. Edwards Comment Letter); and Letter from National Quotation Bureau, LLC, (April 27, 1998) (NQB Comment Letter).

exclusion to investment grade asset-backed securities at this time.

<sup>41</sup> Proposing Release, 63 FR at 9669. Also, we are combining into a single provision the current exceptions for exchange-listed and Nasdaq securities.

<sup>42</sup> For a discussion of the requirements under the reproposed amendments concerning the submission of information to the NASD, see Part III.I. below.

<sup>43</sup> 15 U.S.C. 781(k).



Commenters stated that the Rule's review requirements represented a shift from the Commission and the SROs to broker-dealers of the burdens of overseeing issuer compliance with regulatory requirements.<sup>46</sup> Some commenters wrote that the annual review is only appropriate for certain non-reporting companies or issuers for which only limited information is available. Other commenters stated that the annual review should not apply to issuers that are current in their reporting requirements because this information is available on EDGAR.<sup>47</sup> A number of commenters, however, generally supported some sort of required annual review for broker-dealers publishing priced quotations, although they differed as to the securities that should be subject to this provision.<sup>48</sup>

The amendments will apply the annual review requirement to priced quotations for both reporting and non-reporting issuers' securities. We believe that an annual review requirement for both reporting and non-reporting issuers' securities fulfills the objectives of the Rule without imposing significant burdens on broker-dealers. This is especially so because we are revising the Rule to cover only those securities that, in our view, are most likely to be the subject of microcap fraud schemes and are also limiting the scope of the annual review to priced quotations. We also note that because information about reporting issuers is available on the Commission's website, the review of information about these issuers can be accomplished quite easily.

Commenters are requested to provide us with their views on the reproposal's focus on priced quotations.

Q19. Should the Rule cover all broker-dealers' initial quotations, whether priced or unpriced, as the earlier proposal would have? Will the reproposal cause broker-dealers to publish unpriced quotes to avoid complying with the Rule?

Q20. Should the Rule apply exclusively to priced quotes, *i.e.*, the Rule would not cover any unpriced quotes?

Q21. Are there other approaches that would be more appropriate, *e.g.*, to cover any initial quote for a covered OTC security by a broker-dealer, whether priced or unpriced, but not to apply the Rule or at least the annual review requirement to reporting issuers'

securities? How would such a proposal help reduce instances of microcap fraud?

Q22. Is the Rule text sufficiently clear in identifying the quotation events that are subject to the Rule's provisions? Are there other quotation events that should be covered by the Rule?

Q23. Should the provision pertaining to a lapse in quotations of five consecutive business days or more provide for a longer time period, *e.g.*, ten consecutive business days without a priced quotation, or a shorter time period, *e.g.*, three consecutive business days without a priced quotation?

Q24. Should the Rule give broker-dealers the option to conduct the annual review as of the anniversary date of the initial quotation by the broker-dealer?

### C. Information Required Under the Rule

The amendments are substantially identical to the earlier proposal with respect to the issuer information that a broker-dealer must review before publishing a quotation for a covered OTC security. Under the reproposal, a broker-dealer subject to the Rule must gather, review, and maintain in its records the following issuer information:

- For an issuer that has conducted a recent public offering either registered under the Securities Act of 1933 (Securities Act) or effected pursuant to Regulation A under the Securities Act, a copy of the prospectus or offering circular;
- For an issuer that files reports with the Commission pursuant to Sections 13 or 15(d) of the Exchange Act<sup>49</sup> (reporting issuer), the issuer's most recent annual or semi-annual report and any subsequent quarterly and current reports;
- For an issuer that is an insurance company of the kind specified in Section 12(g)(2)(G) of the Exchange Act,<sup>50</sup> the issuer's most recent annual statement referred to in Section 12(g)(2)(G)(i);
- For an issuer that is not required to file reports pursuant to Sections 13 or 15(d) of the Exchange Act and that is a bank or savings association, the issuer's most recent annual report and any subsequent reports filed with its appropriate federal or state banking authority; and
- For any other issuer, the information, including certain financial information, specified in proposed paragraph (c)(6) of the Rule, which must be reasonably current in relation to the day a quotation is submitted.

The broker-dealer also must obtain and review the supplemental information contained in paragraph (d) of the repropose Rule. A broker-dealer must review a copy of any trading suspension order issued under Section 12(k) for any of the issuer's securities during the 12 months preceding the publication of the quotation, as well as any other material information, including adverse information, that comes to the broker-dealer's knowledge or possession before publication of the quotation. A broker-dealer must consider this supplemental information, along with the issuer information, when it determines whether it has a reasonable basis for believing that the issuer information is accurate and from reliable sources. While we are not including a requirement that the broker-dealer obtain and review any trading suspension for a foreign security that was issued by a foreign financial regulatory authority, this information must be taken into account by the broker-dealer if it comes to the broker-dealer's knowledge or possession at the time that a review is required.

In addition, the broker-dealer must make a record of the significant relationship information contained in paragraph (e) of the repropose Rule, which is unchanged from the Proposing Release. Under this provision, a broker-dealer would have to document specified information such as whether the broker-dealer has any affiliation with the issuer or arrangements to receive any consideration to publish the quote, and whether the quote is being published on behalf of another broker-dealer or the issuer, any of its insiders, or any large shareholder.

Commenters generally did not object to the issuer, significant relationship, and supplemental information requirements; in fact, some commenters favored the enhanced information requirements for non-reporting issuers.<sup>51</sup> Therefore, we are repropose these requirements without any substantive changes, other than revisions relating to financial statements for non-reporting issuers, as discussed

<sup>51</sup> In response to the 78 comment letters that we received from issuers of securities quoted on the OTC Bulletin Board who were concerned about continued liquidity for their securities, we note that 33 of these issuers are reporting companies. Also, under recently approved amendments to NASD Rules 6530 and 6540, all of these issuers ultimately will need to be reporting companies current in their reporting obligations in order for their securities to remain on the OTC Bulletin Board. See note 6 above and accompanying text. There should be no burdens on reporting issuers to provide information to broker-dealers wishing to publish quotations because the issuer information should be available on EDGAR, as long as the issuers are current in their reporting obligations.

<sup>46</sup> See, *e.g.*, A.G. Edwards Comment Letter.

<sup>47</sup> See, *e.g.*, NQB Comment Letter.

<sup>48</sup> See Letter from NASD Regulation, Inc., (July 17, 1998) (NASD Comment Letter); Letter from North American Securities Administrators Association, Inc., (April 27, 1998) (NASAA Comment Letter); and SIA Comment Letter.

<sup>49</sup> 15 U.S.C. 78m and 78o(d).

<sup>50</sup> 15 U.S.C. 78l(g)(2)(G).



below in Part III.C.4. We are addressing below specific points that a few commenters raised about the information requirements and other provisions. Commenters are welcome to provide their views on the information requirements for the various categories of issuers and should consult the Proposing Release for a more detailed description of these provisions.<sup>52</sup>

#### 1. Reporting Issuers Delinquent in Their Filings

In the case of an issuer delinquent in its reporting obligations, a broker-dealer will not be able to publish an initial priced quotation, or continue to publish priced quotations after the annual review date, because it will not be able to obtain the specified reports. A few commenters indicated concern about the possible adverse implications for the market for delinquent issuers' securities if broker-dealers could not publish quotes when current issuer information was unavailable.<sup>53</sup> As noted above, we are revising the Rule to permit broker-dealers to publish unpriced quotations, even in the absence of current issuer information (except in the case of the first quotation for the security).

#### 2. Issuers in Bankruptcy

##### a. Reporting Issuers

A few commenters urged us to permit broker-dealers to continue to quote the securities of reporting issuers that had filed for reorganization under federal bankruptcy law because it would provide liquidity for these securities.<sup>54</sup> They noted that it was often burdensome for small companies that had filed for reorganization under Chapter 11 of the Bankruptcy Code<sup>55</sup> to produce audited financial statements to comply with Exchange Act reporting requirements.

Commenters suggested that broker-dealers could satisfy the Rule's requirements by reviewing bankruptcy court filings made by an issuer in

Chapter 11 reorganization when current Exchange Act reports were unavailable. One commenter also suggested that the Commission permit delinquent reporting companies that experience a 51% ownership change as a result of a confirmed plan of reorganization to begin reporting from the effective date of the reorganization plan with a filing with the Commission, attaching the court-approved disclosure statement together with a certified audited balance sheet as of the effective date.<sup>56</sup>

The reproposal will require a broker-dealer publishing quotations for a reporting issuer's securities to obtain the issuer's Exchange Act reports, even if the reporting issuer has filed for Chapter 11 reorganization. Thus, if a reporting issuer that has filed for Chapter 11 reorganization becomes delinquent in its reporting obligations, a broker-dealer will not be able to publish priced quotations covered by the Rule. For example, a broker-dealer could not continue to publish priced quotations as of the annual review date for a covered security of a reporting debtor that has become delinquent in its reporting obligations.<sup>57</sup>

The bankruptcy court filings for an issuer undergoing reorganization under Chapter 11 are not adequate to satisfy the Rule's requirements. These Rule 2015 bankruptcy reports ordinarily contain only data about issuer receipts and disbursements and not the type of issuer financial information contemplated by Rule 15c2-11.<sup>58</sup> In some cases, our Division of Corporation Finance may grant issuers in bankruptcy no-action relief with respect to Exchange Act filing requirements.<sup>59</sup> These no-action positions, however, are predicated on little or no trading occurring in the debtor's securities. The Rule 2015 bankruptcy reports that the Division of Corporation Finance accepts under its no-action position do not

satisfy Rule 15c2-11 because this financial report usually contains only information about issuer receipts and disbursements. Where a reporting issuer receives this type of no-action position, a broker-dealer would not be able to obtain the issuer information required by the Rule until the debtor's reorganization plan becomes effective, and the debtor files a Form 8-K, which instead of attaching the Rule 2015 bankruptcy reports, now includes the issuer's audited balance sheet. Under Rule 15c2-11, broker-dealers could review this 8-K, which contains an issuer's audited balance sheet, and then publish priced quotations. From then on, the issuer must file its Exchange Act periodic reports for all periods that begin after the plan becomes effective.<sup>60</sup> The publication of quotations by a broker-dealer indicates that a market exists for the issuer's securities. It would be inconsistent with the premise of the no-action position (*i.e.*, that there is no trading in the issuer's securities) if a broker-dealer were able to stimulate trading by publishing quotations without having the issuer's Exchange Act reports.

Q25. Are there circumstances in which a broker-dealer should be permitted to publish priced quotations for the securities of delinquent reporting issuers in bankruptcy? Please describe these circumstances. Should the Rule prohibit broker-dealers from publishing unpriced quotes for the securities of these issuers?

##### b. Non-Reporting Issuers Emerging From Bankruptcy

The Proposing Release contained amendments to permit broker-dealers that quote the securities of non-reporting companies emerging from bankruptcy to review the bankruptcy court-approved disclosure statement and issuer financial information required by the Rule from the date that the bankruptcy court confirms the reorganization plan.<sup>61</sup> The commenters who addressed this issue supported the proposal to limit a broker-dealer's review to the post-reorganization information.<sup>62</sup> The amendments are unchanged from the original proposal.

<sup>52</sup> See Part II.A.4. of the Proposing Release at 63 FR 9661, 9664-9669.

<sup>53</sup> See, *e.g.*, NASAA Comment Letter.

<sup>54</sup> See, *e.g.*, Letter from Daniel J. Demers (March 27, 1998) (Demers Comment Letter); Letter from Robotti & Company, Inc., (April 27, 1998) (Robotti Comment Letter); and NQB Comment Letter. In 1989, we sought comment on whether there were situations, such as bankruptcy, that should be addressed if the piggyback provision were revised. See Securities Exchange Act Release No. 27247 (September 14, 1989), 54 FR 39194 (1989 Release). Commenters on the 1989 Release argued that it was appropriate to permit broker-dealers to continue quoting the securities of issuers that had filed for bankruptcy because it provided liquidity for these securities and suggested that issuers in bankruptcy be identified in the quotation system by using a special indicator.

<sup>55</sup> 11 U.S.C. 1101 *et seq.*

<sup>56</sup> Demers Comment Letter; see also 11 U.S.C. 1125. The disclosure statement includes, among other things, a description of the issuer's business plan, a description of any securities to be issued, and financial information.

<sup>57</sup> Broker-dealers would be able to continue to publish unpriced quotations.

<sup>58</sup> See Federal Rule of Bankruptcy Procedure 2015 (Rule 2015 bankruptcy reports).

<sup>59</sup> See Staff Legal Bulletin No. 2 (April 15, 1997) (CF) (Staff Legal Bulletin No. 2), which is available through our Internet website at <<http://www.sec.gov/rules/other/slb2.txt>>. Under Staff Legal Bulletin No. 2, our Division of Corporation Finance has granted no-action relief permitting an issuer in Chapter 11 reorganization to satisfy its Exchange Act reporting obligations by filing the Rule 2015 bankruptcy reports on Exchange Act Form 8-K. See 17 CFR 249.308. Under Staff Legal Bulletin No. 2, the staff has allowed a company to substitute its Rule 2015 bankruptcy reports for its Exchange Act periodic reports when there is little or no trading in the debtor's securities.

<sup>60</sup> See Staff Legal Bulletin No. 2.

<sup>61</sup> See 11 U.S.C. 1125. The disclosure statement includes, among other things, a description of the issuer's business plan, a description of any securities to be issued, and financial information.

<sup>62</sup> See Letter from Florida Division of Securities (April 27, 1998) (Florida Comment Letter); NQB Comment Letter; Demers Comment Letter; and Robotti Comment Letter. Mr. Demers suggested that the required financial information for non-reporting issuers emerging from bankruptcy be from the "effective date" of the plan, instead of the "confirmation date" of the plan. We are retaining

### 3. Non-Reporting Foreign Private Issuers

In the case of a foreign private issuer that relies on an exemption from registration under Section 12(g)<sup>63</sup> of the Exchange Act by complying with Exchange Act Rule 12g3-2(b), Rule 15c2-11 specifies that a broker-dealer must review the information submitted to the Commission under Rule 12g3-2(b).<sup>64</sup> To qualify for the registration exemption, the issuer must furnish to the Commission information that the issuer has made or is required to make public under the law of the country in which the foreign private issuer is domiciled or incorporated; has filed or is required to file with a stock exchange on which the securities are traded and which the exchange has made public; or has distributed or is required to distribute to its securityholders. For foreign private issuers that do not furnish the Commission with information under Rule 12g3-2(b), the Rule currently requires broker-dealers to obtain and review the same kind of information, including financial information, as required for non-reporting domestic issuers.

We note that Rule 12g3-2(b) contains no specific requirements governing the categories of information the issuer must furnish to the Commission under the exemption. As a result, there is no assurance that broker-dealers publishing quotes will obtain the same type of information for each foreign private issuer that claims the Rule 12g3-2(b) exemption as they must for other non-reporting foreign private issuers. This can be problematic since a number of issuers claiming the Rule 12g3-2(b) exemption are foreign microcap companies that can potentially be subject to the same kinds of abusive practices as their U.S. counterparts.

Therefore, we are proposing to change Rule 15c2-11 requirements with respect to quotations for the securities of foreign issuers complying with Rule 12g3-2(b). Broker-dealers publishing quotations for the securities of Rule 12g3-2(b) issuers will have to obtain and review the information specified in paragraph (c)(6) of the repropoed Rule.<sup>65</sup> However, as described in more detail below, we propose to revise the financial statements that must be reviewed for non-reporting foreign private issuers to

recognize the foreign status of these issuers.<sup>66</sup> By eliminating the provision for Rule 12g3-2(b) issuers, all non-reporting foreign private issuers will be treated similarly under Rule 15c2-11.

Commenters were divided on whether we should amend the provisions of the Rule governing the review of information for non-reporting foreign private issuers.<sup>67</sup> Because the reproposal excludes the securities of many larger foreign issuers from Rule 15c2-11 and also distinguishes between U.S. and foreign accounting standards for those foreign issuers that continue to be covered, many of the reasons for permitting broker-dealers to rely on Rule 12g3-2(b) information have been addressed.

Q26. Should broker-dealers be required to obtain and review the same type of issuer information with respect to non-reporting foreign private issuers providing information under Rule 12g3-2(b) as they must for other non-reporting foreign issuers? Are there reasons to retain a special provision in Rule 15c2-11 for foreign issuers furnishing information under Rule 12g3-2(b)?

Q27. What is the experience of broker-dealers under the Rule when the foreign issuer has not furnished information to the Commission under Rule 12g3-2(b)? How difficult or easy will it be for broker-dealers to obtain the paragraph (c)(6) information for a non-reporting foreign private issuer?

### 4. Other Non-Reporting Issuers

The amendments parallel the Proposing Release in their treatment of non-reporting issuers (*i.e.*, those non-reporting issuers that are not financial institutions covered by paragraph (c)(4)), except for the new exclusions discussed in Part III.A. above and the revisions to the required financial information for non-reporting issuers. As in the Proposing Release, the Rule will require broker-dealers to review more information than currently required about the issuer's outstanding securities; the issuer's insiders, including their disciplinary history; and certain significant events involving the issuer, among other items. This information will provide a broker-dealer that is considering whether to publish

quotations for such an issuer greater understanding of the issuer's operations and a better indication of whether potential or actual fraud or manipulation may be present.

Several commenters supported the requirement for a broker-dealer to review the disciplinary information about the insiders of non-reporting issuers. One commenter believed that if broker-dealers are allowed to publish quotations without obtaining this disciplinary information, it would create a loophole for issuers to avoid disclosing information that would be of utmost importance and would thereby defeat the goal of the Commission.<sup>68</sup> While no commenters directly opposed the requirement to obtain disciplinary information, several commenters objected to the enhanced information requirements in general as too difficult and burdensome, especially when issuers are unwilling to volunteer information.<sup>69</sup>

Q28. Should the Rule require the disciplinary history information for the insiders of all issuers of covered OTC securities, and not just insiders of non-reporting issuers, on the basis that microcap fraud can involve issuers whose insiders have histories of prior misconduct?

We are proposing to amend the financial information that a broker-dealer must review when publishing quotations of both domestic and foreign non-reporting issuers. The reproposal lists the financial statements required for a domestic issuer, which must be prepared in accordance with U.S. GAAP, and sets forth when these financial statements will be presumed "current" under the Rule. Absent contrary information, a domestic issuer's balance sheet will be considered current if it is as of a date that is less than 15 months before the quotation is published, rather than less than 16 months as now specified in the Rule.<sup>70</sup> This revision comports with existing Exchange Act requirements regarding when a domestic reporting issuer's financial statements are considered

<sup>68</sup> See NASAA Comment Letter.

<sup>69</sup> See, *e.g.*, Letter from David B. Schneider (April 21, 1998).

<sup>70</sup> This provision is a presumption that financial information that is less than 15 months old is current. However, if the broker-dealer has other information that indicates that the issuer's financial condition has materially changed from that shown in the financial statements, this presumption may not apply, and the broker-dealer should determine whether more recent financial information is available. Financial information older than 15 months is not current and does not satisfy the Rule's requirements. The presumption for non-financial information is that this information is considered current if it is as of a date within 12 months of publication of the quotation.

this amendment from the confirmation date because adequate information is available about the non-reporting issuer at this point for Rule 15c2-11 purposes.

<sup>63</sup> 15 U.S.C. 78l(g).

<sup>64</sup> 17 CFR § 240.12g3-2(b).

<sup>65</sup> Some of the paragraph (c)(6) information that broker-dealers will have to obtain and review may be present in the foreign issuer's Rule 12g3-2(b) materials.

<sup>66</sup> See Part III.C.4. below.

<sup>67</sup> For example, some commenters stated that we should delete the reference to Rule 12g3-2(b) and require broker-dealers to review the same information as required for all other foreign non-reporting issuers whose securities are subject to Rule 15c2-11. See, *e.g.*, Florida Comment Letter. Other commenters, however, indicated that we should continue to require broker-dealers to review only the home country information that certain foreign issuers submit to the Commission under Rule 12g3-2(b). See, *e.g.*, SIA Comment Letter.

current. The reproposal also will require broker-dealers to review the specified financial information for such part of the two preceding fiscal years (in the case of the balance sheet, the preceding fiscal year) that the issuer (or any predecessor) has been in existence.

The reproposal also will revise the requirements with respect to the financial statements that broker-dealers must review when publishing a quotation for a non-reporting foreign private issuer's security. The reproposal lists the financial statements that the broker-dealer must review, which must be prepared in accordance with a comprehensive body of accounting principles, and sets forth when these financial statements will be considered current under the Rule. For a non-reporting foreign private issuer, its balance sheet will be presumed current if it is as of a date less than 18 months before the quotation is published.<sup>71</sup> Also, if the balance sheet is as of a date more than 9 months before the quotation is published, the broker-dealer must obtain more current financial information only to the extent that the issuer has prepared it. The broker-dealer must obtain the specified financial information for the two preceding fiscal years (one year with respect to the balance sheet) that the issuer has been in existence.

Q29. Are the financial statement requirements, including the presumption regarding when the information is considered current, clear and capable of being complied with by broker-dealers publishing quotations? Should there be longer time periods for the presumption regarding when the financial statements for a non-reporting foreign private issuer are considered current? If so, what time periods would be appropriate?

Q30. Are there any information requirements for non-reporting issuers that should be added or removed from proposed paragraph (c)(6)?

#### *D. Information Available Upon Request*

We believe that some microcap frauds could be prevented if there were greater investor access to information about those securities and their issuers. Accordingly, we are reproposing, with some revisions, the requirement that a broker-dealer publishing quotations for any covered OTC security make the information promptly available upon request. In response to the Proposing Release, several commenters suggested that we restrict the types of persons and

entities to which a broker-dealer must provide the information.<sup>72</sup> The amendments require a broker-dealer to provide information upon request to any current customer, prospective customer, information repository, or other broker-dealer.

A few commenters asserted that broker-dealers should not be required to provide information that already is generally available to the public from other sources (e.g., information for reporting companies that is available on EDGAR).<sup>73</sup> We are addressing these concerns in the amendments by requiring broker-dealers to provide the required information that is not accessible through EDGAR, any other federal or state electronic information system, or an information repository. Further, most commenters responding to this issue were concerned about the cost of providing information to others upon request.<sup>74</sup> We believe that the cost of requiring broker-dealers to make the information available (including to other broker-dealers) upon request is minimal.<sup>75</sup>

The amendments retain in substantial form the clause that providing information to others does not constitute a representation by the broker-dealer that the information is accurate. Rather, providing the information to others constitutes a representation that the information is current in relation to the date the information was reviewed, and that the broker-dealer has a reasonable basis for believing that the information was accurate as of the date recorded and was obtained from reliable sources.

Q31. Should we require broker-dealers to make the information available to anyone who requests it, particularly if broker-dealers are permitted to charge reasonable fees? Should broker-dealers be required to provide information to fewer classes of persons?

#### *E. Information Repository*

The amendments, as in the Proposing Release, eliminate the piggyback provision of the Rule. The elimination of the piggyback provision and the potential for increased costs of compliance suggest the desirability of

having a data base of information about the non-reporting issuers of covered OTC securities.<sup>76</sup> Such a data base also would enhance the availability of information about little-known issuers to investors, other professionals, and regulators. The consensus among the commenters who specifically addressed this issue was that the creation of a repository would foster access to information about issuers that do not participate in the public disclosure system.<sup>77</sup> For these reasons, we encourage the development of one or more repositories of Rule 15c2-11 information, but we note that the existence of a repository will not be necessary for broker-dealers to comply with the Rule.

The amendments establish that the Commission may, upon written application, designate an entity as an information repository.<sup>78</sup> In determining whether to grant or deny such a designation, the Commission will consider whether an entity:

- Collects information about a substantial segment of issuers of securities subject to the Rule;
- Maintains current and accurate information about such issuers;
- Has effective acquisition, retrieval, and dissemination systems;
- Places no inappropriate limits on the issuers from or about which it will accept or request information;
- Provides access to the documents deposited with it to anyone willing and able to pay the applicable fees; and
- Charges reasonable fees.

In general, the Commission will consider whether an entity wishing to act as an information repository is so organized and has the capacity to be able reasonably to obtain and provide to others current information required by the Rule. An information repository will be required to notify the Commission of any material changes in the facts and circumstances of their application for designation as an information repository. In the event that an information repository no longer satisfies these attributes, we may withdraw such designation.

<sup>76</sup> We note that, for reporting issuers, information repositories already exist. Broker-dealers are able to access and review the required information on our EDGAR system, available through our Internet website at <<http://www.sec.gov>>. In addition, broker-dealers may consult federal or state electronic information systems for information about issuers of covered OTC securities.

<sup>77</sup> See e.g., Letter from Singer Frumento Sichenzia, LLP, (April 13, 1998).

<sup>78</sup> This authority will be delegated to the Director of the Commission's Division of Market Regulation. We propose to amend Rule 200.30-3, which provides for delegation of authority to the Director, to include the designation of information repositories. See 17 CFR 200.30-3.

<sup>71</sup> This presumption will operate in the same manner as for domestic issuers. See footnote 70 above.

<sup>72</sup> See, e.g., Letter from Security Traders Association (April 28, 1998) (STA Comment Letter). We originally proposed that the information be made available to anyone upon request.

<sup>73</sup> See e.g., Letter from Richard P. Ryder, Esq. (May 12, 1998).

<sup>74</sup> See e.g., Letter from The Bond Market Association Comment Letter (April 27, 1998); NQB Comment Letter; and Florida Comment Letter.

<sup>75</sup> A broker-dealer may charge for the reasonable expenses it incurs in producing and forwarding copies of the Rule 15c2-11 information.

Some commenters suggested that the Commission assume the task of serving as the Rule 15c2-11 information repository.<sup>79</sup> Because the issuers that would be the focus of any information repository generally would not be required to file periodic reports with the Commission, this is not a function that we can assume at this time. The NASD has also advised us preliminarily that it is unable to undertake the responsibility of serving as an information repository at the present time. Therefore, we encourage private sector initiatives for the creation of one or more Rule 15c2-11 information repositories.

Q32. Are there other criteria that should be used to determine the information repository designation?

#### F. Definitions

Reproposed paragraph (j) of the Rule sets forth the definitions applicable to all provisions of the Rule. Most of the definitions are unchanged from the Proposing Release, but a few definitions are revised to respond to commenters' suggestions or to add clarity to the amendments.

**Quotation Medium.** The current definition of "interdealer quotation system" will be incorporated into the definition of "quotation medium" in paragraph (j)(12).<sup>80</sup> This definition of quotation medium is quite inclusive: it covers any publication, alternative trading system (ATS), or other device that is used by brokers or dealers to make known to others their interest in transactions in any security, including offers to buy or sell at a stated price or otherwise, or invitations of offers to buy or sell.<sup>81</sup> A few ATSs expressed concern about whether they would have to comply with the Rule's information review requirements with regard to any covered OTC security that is traded on their systems by broker-dealer subscribers to such ATSs.<sup>82</sup> ATSs are included in the definition of "quotation medium" if they display subscriber orders to any person other than ATS employees. The Rule's information review requirements, however, apply

only to the broker-dealers that submit quotations for publication by the ATS, and not to the ATS functioning as the quotation medium for them. The Rule will apply to an ATS only if, as a registered broker-dealer, it displays its own orders in the ATS.

An issue has also been raised about whether Rule 15c2-11 applies to broker-dealers submitting orders through an ATS. We understand that some broker-dealers have taken the position that compliance with Rule 15c2-11 is not necessary when they submit an order through an ATS.<sup>83</sup> They have viewed such an order for the security as not constituting a quotation within the meaning of Rule 15c2-11. These orders may represent transactions for the broker-dealer's own account. The Rule's definition of quotation makes clear that the Rule covers any indication of interest by a broker or dealer in receiving bids or offers from others for a security, or any indication by a broker or dealer that it wishes to advertise its general interest in buying or selling a particular security. Thus, broker-dealers are subject to the Rule when they place any indication of interest in any quotation medium, including an ATS, that they wish to receive bids or offers in a covered OTC security, unless they can rely on one of the Rule's exceptions.<sup>84</sup>

Also, we are clarifying the Rule's application to broker-dealers that publish quotations in multiple quotation mediums or move their quotations from one quotation medium to another. If the broker-dealer complies with the Rule's provisions, based upon a review of information, it may publish quotations in one or more quotation mediums.<sup>85</sup>

<sup>79</sup> For example, some broker-dealers have claimed to submit customer "orders" in quotations mediums following the termination of a Commission trading suspension issued under Exchange Act Section 12(k).

<sup>80</sup> To rely on the exception for an unsolicited customer order, the order must represent an unsolicited indication of interest of a customer (other than a person acting as or for a dealer) of the broker-dealer submitting the order to the ATS.

<sup>81</sup> We have previously interpreted the Rule to require a broker-dealer that was publishing quotations in a particular interdealer quotation system to review issuer information before publishing quotations in another interdealer quotation system unless it relied upon an exemption. See *Letter re: OTC Bulletin Board Display Service* (December 20, 1993) (conditional exemption permitting broker-dealers that are currently publishing quotations in an interdealer quotation system to publish quotations in the OTC Bulletin Board without reviewing issuer information under the Rule); and *Letter re: OTC Bulletin Board; Modification of Exemption* (December 1, 1998) (modifying the exemption granted in 1993). Upon adoption of the reproposed amendments, we will rescind this interpretation and related exemptions.

**Net tangible assets.** We are proposing to add a definition to the Rule to assist broker-dealers in assessing whether or not a security can meet the proposed exception to the Rule for securities of issuers with net tangible assets exceeding \$10 million. Net tangible assets means total assets less intangible assets and liabilities and this determination must be based on the issuer's current financial statements, which must be audited.

#### G. Preservation of Documents and Information

To facilitate compliance with the Rule's recordkeeping requirements, we believe that it is appropriate to codify the Rule's record preservation requirements in Rule 17a-4,<sup>86</sup> rather than in Rule 15c2-11. Rule 17a-4 obligates broker-dealers to preserve documents and information that they must compile pursuant to Commission rules for the time period and in the manner specified in the various provisions of Rule 17a-4. As in the Proposing Release, Rule 17a-4 would be amended to add the information specified in reproposed paragraphs (c), (d), and (e) of Rule 15c2-11 to the other information that broker-dealers are already required to preserve under Rule 17a-4.<sup>87</sup>

With regard to issuer information that is accessible to broker-dealers through our EDGAR system, any other federal or state electronic information system,<sup>88</sup> or an information repository, the amendments provide different requirements. If broker-dealers obtain and review the information contained on such systems, they will not need to preserve such information separately, as long as they document the review and the information is accessible on such system for the same period of time that

<sup>86</sup> 17 CFR 240.17a-4. We will add new paragraph (b)(11).

<sup>87</sup> This proposed recordkeeping requirement was discussed by few commenters and generally was viewed favorably. See e.g., NASAA Comment Letter.

<sup>88</sup> Broker-dealers publishing quotes for securities of exempt financial institutions may obtain the regulatory reports from the financial institution by contacting their primary bank regulatory agency. Broker-dealers can access the Federal Reserve System's National Information Center of Banking Information Internet website at <<http://www.ffiec.gov/NIC>>, the Office of the Comptroller of the Currency's Internet website at <<http://www.occ.treas.gov>>, which has information about individual nationally chartered banks, or the Federal Deposit Insurance Corporation's (FDIC) Internet website at <<http://www.fdic.gov>>, which provides the most recent Call Reports for all FDIC insured banks. Broker-dealers that access exempt financial institution information through these websites would be able to satisfy the Rule's requirements by recording their review and preserving the information in the same manner as for EDGAR information discussed above.

<sup>79</sup> See, e.g., STA Comment Letter.

<sup>80</sup> Under the current Rule, *interdealer quotation system* is defined as any system of general circulation to brokers or dealers which regularly disseminates quotations of identified brokers or dealers. A separate definition of "interdealer quotation system" is no longer necessary because of the proposed elimination of the piggyback provision and the revision that the information be furnished to the NASD in accordance with NASD rules, rather than to interdealer quotation systems.

<sup>81</sup> We are using the term "alternative trading system," which encompasses the term "electronic communications network." See Securities Exchange Act Release No. 40760 (December 8, 1998), 63 FR 70844.

<sup>82</sup> See e.g., Letter from Instinet (April 22, 1998).

the broker-dealers are obligated to preserve such information pursuant to Rule 17a-4.

#### *H. Transition and Exemptive Authority Provisions*

We are reproposing the transition provision covering quotations by broker-dealers that were initiated prior to the effective date of the proposed amendments and, with a slight modification, the provision giving the Commission the authority to grant exemptions from the Rule.<sup>89</sup> These proposed provisions were viewed as adequate by the few commenters who discussed them.<sup>90</sup>

#### *I. Information submitted to the NASD*

Rule 15c2-11 currently requires any broker-dealer covered by the Rule to submit the information required under paragraph (a)(5) (*i.e.*, for non-reporting issuers) to the interdealer quotation system, in the form prescribed by the system, at least three business days before submitting a quotation for publication. We intend to amend this obligation by requiring broker-dealers to submit the information that they must review only to the NASD, in accordance with the NASD's rules.

The amendments are substantially the same as originally proposed, except for one change. Under the Proposing Release, a broker-dealer would be in compliance with the requirement to obtain current reports filed by a reporting issuer, if the broker-dealer obtained all current reports filed with the Commission by an issuer as of a date up to three business days before the earlier of the date the broker-dealer submitted the quotations to the quotation medium and the date the broker-dealer submitted information to the NASD. To reduce the chance that a broker-dealer would overlook a recently filed report containing material issuer information, we are proposing to eliminate the reference to the date the information was submitted to the NASD. This means that a broker-dealer would be required to obtain current reports filed by a reporting issuer after the broker-dealer had submitted information to the NASD, if such reports were filed more than three business days in advance of the publication of the quotation.

#### **IV. General Request for Comments**

We solicit comment on all aspects of the amendments to Rule 15c2-11, as

well as on any other matter that might have an impact on the reproposal discussed above. In particular, we seek comment on the whether the reproposal will help focus the Rule on those securities and quotations most likely to be involved in microcap fraud. Commenters are requested to address whether there are other ways to amend the Rule that would help reduce fraud and manipulation in the OTC market. Commenters also are invited to address whether the Rule's text is sufficiently clear and understandable, or whether it can be simplified without sacrificing its purposes. We also request commenters to provide us with their views regarding whether the original proposal, or aspects of it, are preferable to the reproposal.

We encourage commenters to focus on the various provisions of the reproposal and bring to our attention any compliance or other specific issues that they may encounter if the reproposal is adopted. Commenters are urged to provide us with their views as expeditiously as possible so that we can complete our review of Rule 15c2-11.

#### **V. Effects on Efficiency, Competition, and Capital Formation**

Section 23(a)(2) of the Exchange Act requires the Commission, in adopting rules under the Exchange Act, to consider the anti-competitive effects of any rules it adopts thereunder, and to not adopt any rule that would impose a burden on competition not necessary or appropriate in the public interest.<sup>91</sup> Furthermore, Section 3(f) of the Exchange Act<sup>92</sup> requires the Commission, when engaged in rulemaking, to consider or determine whether an action is necessary or appropriate in the public interest, and whether the action will promote efficiency, competition, and capital formation.

We preliminarily believe that the reproposal would not have any anti-competitive effects that are not necessary or appropriate in the public interest. By applying the Rule to the first broker-dealer publishing any quotations for a security in a quotation medium and to other broker-dealers publishing priced quotations thereafter, the availability of information about issuers of covered OTC securities should be increased. This should help improve the level of competition among broker-dealers publishing priced quotations and enhance the extent of information about OTC issuers that is available to the investing public. Moreover, by

excluding unpriced quotations from the Rule, anti-competitive burdens will be reduced because broker-dealers that cannot, or do not want to, obtain the specified information can still advertise their interest in buying or selling a particular OTC security in a quotation medium. Finally, the reproposal should have a beneficial impact on capital formation because microcap fraud ultimately increases the costs of raising capital for legitimate smaller issuers. Investors may be less willing to commit their resources if they are concerned about fraudulent activities in OTC securities.

We request comments on the benefits, as well as the adverse consequences, that may result with respect to efficiency, competition and capital formation, if the reproposal is adopted.

#### **VI. Costs and Benefits of the Amendments**

We request commenters to evaluate the costs and benefits associated with the amendments to Rule 15c2-11. We have identified certain costs and benefits relating to the reproposal, which are discussed below, and encourage commenters to discuss any additional costs or benefits. In particular, we request comments on the potential costs for any necessary modifications to information gathering, management, and reporting systems or procedures that would be necessary to implement the amendments, as well as any potential benefits resulting from the reproposal for issuers, investors, broker-dealers, securities industry professionals, regulators or others. Commenters should provide analysis and data to support their views on the costs and benefits associated with the amendments.

##### *A. Benefits*

Incidents of microcap fraud frequently involve issuers for which public information is limited.<sup>93</sup> Without information, it is difficult for investors, securities professionals, and others to evaluate the risks presented by these securities. Consequently, many investors fall prey to persons who make false representations and unrealistic predictions about these securities. The publication of quotations by broker-dealers can facilitate the fraudulent promotion of microcap securities.

In our view, the reproposal generally would improve the quality of the markets for securities subject to Rule 15c2-11 and would help protect

<sup>89</sup> The reproposal would provide the Commission with the authority to grant an exemption from the Rule for any quotation for a security or any class of security.

<sup>90</sup> See, e.g., Florida Comment Letter.

<sup>91</sup> 15 U.S.C. 78w(a)(2).

<sup>92</sup> 15 U.S.C. 78c.

<sup>93</sup> See, e.g., *SEC v. Global Financial Traders, Ltd.*, Litigation Release Nos. 15291 (March 14, 1997), and 15338 (April 17, 1997).

investors from fraudulent schemes involving these securities. The reproposal is focused on the OTC-quoted securities of smaller issuers. Absent the amendments, we believe that some broker-dealers would submit quotations without regard to basic information about relatively unknown issuers. In our view, when broker-dealers must review specified issuer information before publishing priced quotations, they are less likely to become unwitting participants in unlawful schemes of unscrupulous broker-dealers or promoters. Market makers in the securities of legitimate microcap issuers, as well as the issuers themselves, also would benefit from improving the integrity of this market sector. One benefit of the reproposal is that the scope of the Rule will be revised so that broker-dealers will not have to obtain information about those securities that satisfy any one the proposed alternative tests.

We also believe that the amendments will serve an important surveillance function. Currently, only the first broker-dealer quoting a security in a quotation medium must gather, review, and preserve the information. The amendments will require the first broker-dealer initiating any quotation and all broker-dealers initiating priced quotations thereafter to satisfy the Rule's information review requirements. Moreover, under NASD Rule 6740,<sup>94</sup> broker-dealers demonstrate their compliance with that rule by filing the Rule 15c2-11 information with the NASD. Recently, the review of Forms 211 filed with the NASD has resulted in a number of Commission trading suspensions and other enforcement actions.

The amendments require broker-dealers publishing quotes in compliance with the Rule to provide the information upon request to any customer, prospective customer, other broker-dealers, or information repository unless the information is available through a government sponsored database. This amendment will help make information about non-reporting issuers more widely available to the public.

We also believe that the amendments will ease significantly the Rule's recordkeeping requirement because broker-dealers will not have to retain information that is available on the Commission's EDGAR system or on the information systems of other federal or state authorities. Access to EDGAR and similar government-sponsored information systems is free on the Internet. Given that approximately 60%

of securities on the OTC Bulletin Board and Pink Sheets are issued by reporting companies, whose reports are included on EDGAR, a significant recordkeeping cost savings to broker-dealers should result.

We do not have the data to quantify the value of the benefits described above. We seek comments on the value of these benefits and on any benefits, not already identified, that may result from the adoption of the amendments.

#### B. Costs

We anticipate that the elimination of the piggyback provision will create the most significant costs that the industry will incur. Currently, only those broker-dealers that publish quotations during the first 30 days of the security's trading are required to obtain and review the specified information before they initiate quotations. As repropounded, the Rule will continue to require the first broker-dealer, before initiating a priced or unpriced quotation for a covered OTC security in a quotation medium, to review the specified information. Thereafter, the repropounded Rule will impose the review requirement only on broker-dealers publishing priced quotations, including in connection with the annual review requirement. Of course, if the Commission suspends trading under Exchange Act Section 12(k) for any of the issuer's securities, the Rule's requirements are triggered.

The first broker-dealer, before initiating any quotation for a covered OTC security, is currently required to incur the cost of having to gather and review the issuer information. As a result of the amendments, that broker-dealer will incur the cost to update that information annually if it continues to publish priced quotations. Thereafter, any broker-dealer publishing priced quotations for a covered OTC security will incur costs when it first publishes a priced quotation and when it conducts the required annual review. To the extent a broker-dealer does not already have the required information, it will incur costs for the collection and review of this information. Moreover, a broker-dealer also will incur costs associated with creating the records required by the Rule and retaining the Rule's required information for the specified period of time under the amendment to Rule 17a-4.

We estimate that approximately 60% of the issuers of OTC stocks are reporting issuers, while the remaining 40% are non-reporting issuers. Based on this assumption, broker-dealers publishing priced quotations for the OTC securities of reporting issuers should be able to obtain the prescribed

information required by the repropounded Rule from the Commission's EDGAR system and therefore should incur minimal costs to comply with the Rule. We believe that it will take a broker-dealer a maximum of 4 hours to collect, review, record, retain, and supply to the NASD the information pertaining to a reporting issuer, and a maximum of 8 hours to collect, review, record, retain, and supply to the NASD the information pertaining to a non-reporting issuer.<sup>95</sup> We estimate that it will cost a broker-dealer an average cost of \$40 per hour (based on a blended compensation rate for clerical and supervisory compliance staff) to obtain and review the necessary information required by the Rule.<sup>96</sup>

We recently approved changes to NASD Rules 6539 and 6540 to limit the quotations on the OTC Bulletin Board to securities of issuers that are current in their reports filed with us or other regulatory authority, and to prohibit NASD members from quoting a security on the OTC Bulletin Board unless the issuer has made current filings with us.<sup>97</sup> While these NASD Rule changes may result in more issuers choosing to become reporting issuers in order to continue to qualify for quotation on the OTC Bulletin Board, we are at this time unable to adequately quantify the cost impact or burden that the reproposal imposes in relation to these rule changes. However, we believe that, generally, any increase in the number of reporting issuers subject to the Rule will cause a reduction in the number of the burden hours and associated costs. We are of the view that because reporting issuer information is readily available from the Commission's EDGAR system and, because we estimate that broker-dealers only have to spend 4 hours reviewing reporting issuer information, instead of the estimated 8 hours to review non-reporting issuer information, the reduced time spent reviewing issuer information will result in lower costs to broker-dealers.

However, broker-dealers publishing priced quotations for the OTC securities of non-reporting issuers are likely to incur greater costs in complying with

<sup>95</sup> We computed these cost estimates after reviewing, among other sources, responses to a survey of broker-dealers conducted by the NQB about issues raised in the Proposing Release. The results of the NQB's survey are available in File No. S7-3-98 at the Commission's Public Reference Room, 450 Fifth Street N.W., Washington, D.C. 20549.

<sup>96</sup> The cost estimate assumes that clerical staff are paid at an average rate of \$15 per hour and supervisory compliance staff are paid at an average rate of \$100 per hour. The blended compensation rate assumes that 70% of the time is clerical and 30% is supervisory compliance [(0.7 × \$15) + (0.3 × \$100) = \$40].

<sup>97</sup> See OTC Bulletin Board Release.

<sup>94</sup> NASD Manual, Marketplace Rules, Rule 6740.

the Rule. For purposes of the Paperwork Reduction Act, we estimate the total burden hours for all broker-dealers to be 143,278 hours and the total cost to be \$5,731,120. Some broker-dealers may not want to expend the time or the cost to obtain the non-reporting issuer information and may therefore choose not to publish priced quotes. On the other hand, the costs broker-dealers incur in obtaining and reviewing information about non-reporting issuers may be reduced if one or more on-line information repositories of this information are established. We seek comments on the reasonableness of these estimates for annual hourly and dollar costs to broker-dealers. We also seek comments on the extent to which these cost estimates will be affected by the new NASD rule to limit the OTC Bulletin Board to the securities of issuers current in their periodic filings.

Although Rule 15c2-11 does not regulate issuers, there may be some indirect costs imposed on issuers, particularly non-reporting issuers, because they may be contacted by broker-dealers to provide the information specified in the Rule. Non-reporting issuers would incur the cost of having to collect and provide the requested information to each requesting broker-dealer. However, we are assuming that non-reporting issuers maintain their financial information in compliance with prevailing accounting standards and, in most instances, would have available updated financial information prepared in accordance with generally accepted accounting principles (GAAP). The NASD has informed us that financial statements submitted with the Form 211 generally are prepared in accordance with GAAP, and many are audited.

Regarding start-up, operating, and maintenance costs, we believe that broker-dealers that collect, review, and retain the information currently required by the Rule, would incur only marginal start-up, operating, and maintenance costs (*i.e.*, to expand systems already in place) to comply with the Rule as repropounded. Further, some broker-dealers already may be collecting the required information for other purposes. However, we believe that some broker-dealers may not have adequate systems in place to retain issuer information and would, therefore, incur start-up, operating, and maintenance costs in order to comply with the requirements of the amendments.

We estimate that about 100 broker-dealers in the aggregate will incur start-up, operating, and maintenance costs of \$100,000 (\$1,000×100) associated with

reporting issuer information, and \$400,000 (\$4,000×100) associated with non-reporting issuer information. Total start-up, operating and maintenance cost burden for broker-dealers is estimated to be \$500,000 (\$100,000+\$400,000) or an average of \$5,000 for each broker-dealer.

We assume that non-reporting issuers, because they generally maintain their financial information in compliance with prevailing accounting standards, will not incur any start-up costs to prepare the required information in response to broker-dealers' requests. We also believe that reporting issuers of covered OTC securities will not incur start-up costs as a result of the amendments since such issuers already provide the required information to the Commission under the federal securities laws. Therefore, we believe issuers will not incur start-up costs as a consequence of the adoption of the Rule amendments, as repropounded.

Finally, the Rule, as modified by the amendments, could affect the liquidity of some securities. If broker-dealers are unable to obtain the required issuer information, they would have to refrain from publishing priced quotations in that security. This could make it somewhat more difficult for investors to determine what prices other market participants are willing to bid or offer for the security, although they could call a broker-dealer publishing a name-only quotation to obtain a priced quotation. Thus, while investors are still able to obtain price information, the cost of obtaining this information may increase. However, under the reproposal, after the first quotation for a security is published, broker-dealers could publish unpriced quotes without complying with the Rule's provisions. In addition, broker-dealers could rely on the exception that permits them to publish quotes representing unsolicited customer orders.

Any effect on liquidity must be weighed against the benefit of reducing instances of fraud or manipulation. Greater investor access to information should result in more informed investor decisions and potentially could result in additional trading, and thus liquidity, for covered OTC securities. We have modified the proposals to permit broker-dealers to publish unpriced quotations for OTC securities without reviewing the specified information (other than the first broker-dealer to quote the security). This revision responds to the views of those commenters that expressed concerns about the Rule's impact on liquidity.

## VII. Initial Regulatory Flexibility Act

We have prepared an Initial Regulatory Flexibility Analysis (IRFA)<sup>98</sup> regarding the amendments to Rule 15c2-11 and the repropounded companion amendment to Rule 17a-4 under the Exchange Act. The following summarizes the IRFA.

As discussed in the IRFA, the amendments specify the information that a broker-dealer must gather and review before publishing quotations for covered OTC securities. The repropounded Rule is intended to prevent broker-dealers from publishing quotations for covered OTC securities in a quotation medium without obtaining, reviewing, and retaining current information about the issuer. The repropounded Rule applies primarily to priced quotations.

The amendments to the Rule would affect all broker-dealers, including a number of small broker-dealers, seeking to publish quotations for covered OTC securities.<sup>99</sup> The number of small broker-dealers that publish quotations for covered OTC securities in quotation mediums is not known at this time. However, we recently estimated that about 13% of all registered broker-dealers would be characterized as small.<sup>100</sup> We estimate that, at any given time, there are approximately 400 broker-dealers, including small broker-dealers, that submit quotations for covered OTC securities. Therefore, based on this estimate, we believe that approximately 52 small broker-dealers (400×13%) would be affected by the amendments. In fact, it is possible that few, if any, broker-dealers publishing quotations for covered OTC securities would be classified as a small business, because as market makers they typically require more than \$500,000 in capital to support their market making activities. In the Proposing Release, we solicited but did not receive any comments on the number of small broker-dealers that would be affected by the amendments. We are again soliciting comments on the number of small broker-dealers that would be affected by the amendments.

The amendments would indirectly have an impact on those small issuers that may be requested to provide the information required by the Rule to

<sup>98</sup> See 5 U.S.C. 603.

<sup>99</sup> For purposes of the regulatory flexibility analysis, a broker-dealer is considered "small" if its total capital is less than \$500,000, and is not affiliated with a broker-dealer that has \$500,000 or more in total capital.

<sup>100</sup> See Securities Exchange Act Release No. 40122 (June 24, 1998), 63 FR 35508 (adopting amendments to the definitions of "small business" or "small organization" under the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Exchange Act of 1934, and the Securities Act of 1933).



broker-dealers publishing quotations in those issuers' securities. Based on Exchange Act Rule 0-10(a), a small issuer is one that on the last day of its most recent fiscal year had total assets of \$5,000,000 or less. In the Proposing Release, we solicited but did not receive any comments on the total number of issuers of covered OTC securities; the number (or percentages) of these issuers that are small issuers; and the total number (or percentage) of small issuers of covered OTC securities that are reporting and non-reporting issuers, respectively. We are again seeking comments on these issues.

The IRFA notes that the availability of the Commission's EDGAR system and similar systems sponsored by federal or state authorities should assist broker-dealers in collecting and reviewing the reports required by the Rule. In addition, the prevalent use of computers and the Internet, on which access to EDGAR is free, should also reduce the recordkeeping and compliance costs for all broker-dealers by automating the information collection and retention process.

The IRFA recognizes that the amendments indirectly affect certain issuers, particularly non-reporting issuers. The amendments would require the first broker-dealer to publish any quotation for a covered security to review the Rule's information. Thereafter, other broker-dealers must review information about the issuer when they first publish or resume publishing a priced quotation for a covered security, and all broker-dealers publishing priced quotations must conduct an annual review. We are not aware of any information repository, electronically accessible or otherwise, now in existence that covers all of the information about non-reporting issuers that broker-dealers must gather to comply with the Rule. Consequently, non-reporting issuers must collect and provide the required information to each requesting broker-dealer. We assume that non-reporting issuers maintain their financial information in compliance with generally accepted accounting standards and that the costs incurred by non-reporting issuers to prepare the necessary information in response to broker-dealers' requests would be minimal.

The IRFA discusses the kinds of possible alternative proposals that we have considered. These include, among others, creating differing compliance or reporting requirements or timetables that take into account the resources available to small entities, and whether such entities could be exempted from the repropounded rule, or any part thereof.

Therefore, having considered the foregoing alternatives in the context of the amendments, we do not believe they would accomplish the stated objectives of the proposal.

We encourage the submission of written comments regarding any aspect of the IRFA. In particular, we seek comments on: (i) the number of small entities that would be affected by the amendments, including the number of small broker-dealers and issuers; (ii) the number of small entities that are issuers of covered OTC securities; and (iii) the number of small entities that are reporting and non-reporting issuers of covered securities, respectively. Comments should also specify the costs of compliance with the amendments, and suggest alternatives that would meet the objectives of the amendments in a more effective manner, while imposing costs equal to or less than the amendments. In describing the nature of any impact that the amendments would have, empirical data supporting these views should be provided.

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, we are also requesting information regarding the potential impact of the proposed amendments on the economy on an annual basis. In particular, comments should address whether the proposed changes, if adopted, would have a \$100,000,000 annual effect on the economy, cause a major increase in costs or prices, or have a significant adverse effect on competition, investment, or innovations. Commenters should provide empirical data to support their views.

Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549. Comments may also be submitted electronically at the following E-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-5-99; this file number should be included on the subject line if E-mail is used. Comment letters will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW, Washington, DC 20549. Electronically submitted comment letters will also be posted on the Commission's Internet website (<http://www.sec.gov>).

A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting Chester A. McPherson, Office of Risk Management and Control, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549, at (202) 942-0772.

## VIII. Paperwork Reduction Act

Certain provisions of the amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 (PRA).<sup>101</sup> The title for the collection of information is: "Publication or submission of quotations without specified information." Accordingly, the collection of information requirements contained in the Rule and the initial proposal were submitted to the Office of Management and Budget (OMB) for review, in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11, and were approved by OMB. The Rule has been assigned OMB Control No. 3235-0202.<sup>102</sup>

### A. Collection of Information Under the Amendments

As repropounded, the Rule would require the first broker-dealer, before initiating a priced or unpriced quotation for a covered OTC security in a quotation medium, to gather and review the issuer information, and to review updated information annually if it continues to publish priced quotations. This review requirement would also be imposed on any other broker-dealer publishing a priced quotation for a covered OTC security. Broker-dealers submitting priced quotations for the security would be required to collect, review, and retain the Rule's specified information annually. Broker-dealers would also have to record the sources of their information, the date their review occurred, and the person responsible for the review. Also, the proposals would require broker-dealers publishing quotations for a covered OTC security to collect, review, and retain more information than is required currently.

Under Rule 15c2-11, the information that is collected pursuant to the Rule must be submitted to the NASD at least three business days before any quotation is published.<sup>103</sup> Finally, the amendments would require broker-dealers to provide the information specified to any customer, prospective customer, other broker-dealer or information repository that requests it.

<sup>101</sup> 44 U.S.C. 3501 *et seq.*

<sup>102</sup> The Commission notes that a separate PRA filing was not prepared to reflect the proposed companion changes to Rule 17a-4. The burden hours and costs described for the Rule include and account for the anticipated burdens that may arise as a result of the proposed change to Rule 17a-4.

<sup>103</sup> The NASD has a rule requiring broker-dealers that initiate or resume quotations for covered equity securities to submit verification that they have collected the information necessary to comply with NASD requirements, as well as Rule 15c2-11. See *NASD Manual*, Marketplace Rules, Rule 6740.

### B. Proposed Use of Information

Broker-dealers must collect and review the information required under the amendments if they publish the first quotation for a covered OTC security or if they publish priced quotations. Moreover, the Rule requires that broker-dealers have a reasonable basis for believing that the information about the issuer and related persons is accurate and from reliable sources. This information collection protects investors by deterring fraudulent or manipulative quotations for thinly-traded securities whose issuers are relatively unknown. Because information about these issuers is not widely disseminated and often is not current, fraudulent and manipulative schemes are easier to perpetrate. Moreover, this collection of information helps broker-dealers guard against becoming unwitting participants in fraudulent or manipulative schemes. The Rule 15c2-11 information gathering requirements also serve an important surveillance function for both the Commission and the NASD. Recently, the Commission has used the Rule 15c2-11 information to suspend trading in the issuers' securities pursuant to Section 12(k) of the Exchange Act where publicly available information about the issuer raised questions about the accuracy and adequacy of the issuers' disclosures.

### C. Respondents

The amendments would apply to those broker-dealers that publish quotations for a covered OTC security in a quotation medium as of specified quotation events. The amendments also indirectly affect issuers that are asked by broker-dealers to provide this information. Most of the Rule 15c2-11 information that would be required for issuers that publicly file periodic reports with the Commission (reporting issuers) is available electronically on EDGAR or through the Internet. Thus, the reproposal is likely to have a greater paperwork burden when broker-dealers publish quotations for the securities of issuers that do not participate in the Commission's public reporting program, (i.e., non-reporting issuers) or do not file reports with other federal or state regulatory authorities.

### D. Total Annual Reporting and Recordkeeping Burden

The amendments would require broker-dealers to collect, review, retain, and record certain issuer and supplemental information when they are the first broker-dealer to quote the security; when they first publish priced quotations for a covered OTC security;

and if they are publishing priced quotations as of the annual review requirement. The discussion below estimates the collection of information burden one year after the anticipated date of effectiveness of the amendments when broker-dealers that publish quotes for covered OTC securities qualifying for the reproposed transition provision must fully comply with the Rule's information requirements. The discussion below also provides estimates for the same period for issuers that may be contacted to provide the information. In particular, the following analysis measures the cost to broker-dealers of: (1) collecting, reviewing, recording, and retaining the required issuer information and supplying it to the NASD; (2) responding to requests for issuer information from customers, prospective customers, other broker-dealers and information repositories; and (3) starting up or maintaining systems for the collection and retention of issuer information. The analysis below also addresses the indirect cost to issuers who must furnish information to requesting broker-dealers.

#### 1. Burden-Hours for Broker-Dealers

Based on information provided by the NASD and NQB, we estimate that as of December 31, 1998, there were approximately 6,625 covered OTC securities quoted in the OTC Bulletin Board and 3,225 quoted in the Pink Sheets for a total of 9,850 covered OTC securities.<sup>104</sup> We also believe that approximately 10% (985) of these securities would not be subject to the Rule, based on the exceptions that are included in this reproposing Release and that approximately 8,865 securities would be subject to the Rule. According to NASD estimates, we also believe that approximately 1,400 new applications from broker-dealers to initiate or resume publication of covered equity securities in the OTC Bulletin Board and/or the Pink Sheets or other quotation mediums were approved by the NASD for the 1998 calendar year. We have estimated that 60% of the covered OTC securities were issued by reporting issuers, while the other 40% were issued by non-reporting issuers. We also estimate that broker-dealers publish priced quotations for approximately 90% of the covered OTC securities quoted in the OTC Bulletin Board and publish priced quotes for about 10% of the covered OTC securities quoted in the Pink Sheets. According to NASD and NQB

estimates, we believe that, on average, there are approximately 4.3 broker-dealers publishing priced quotations for each covered OTC security, and that at any given time there are no more than 400 broker-dealers that submit priced quotations for covered OTC securities. Finally, the reproposed Rule's transition provision would not subject the broker-dealers quoting the securities of the estimated 8,865 potentially covered securities currently quoted in the OTC Bulletin Board and/or the Pink Sheets until the annual review requirement is triggered. Therefore, only those new applications that are submitted after the reproposal becomes effective would be subject to the initial review requirement.

Because the amendments would require the first broker-dealer publishing a quotation, priced or unpriced, for a particular security to collect issuer information, we believe that during the first year after the amendments are effective, broker-dealers that are publishing the first quotations (whether priced or unpriced) for covered OTC securities in the aggregate would have to conduct approximately 1,260 initial reviews of issuer information.<sup>105</sup> We believe that it will take a broker-dealer about 4 hours to collect, review, record, retain, and supply to the NASD the information pertaining to a reporting issuer, and about 8 hours to collect, review, record, retain, and supply to the NASD the information pertaining to a non-reporting issuer.

We therefore estimate that after the reproposal has become effective, the broker-dealers who are the first to publish the first quote for a covered OTC security of a reporting issuer (priced or unpriced) will require 3,024 hours ( $1,260 \times 60\% \times 4$ ) to collect, review, record, retain, and supply to the NASD the information required by the Rule as reproposed. We estimate that after the reproposal has become effective the broker-dealers who are the first to publish the first quote for a covered OTC security of a non-reporting issuer (priced or unpriced) will require 4,032 hours ( $1,260 \times 40\% \times 8$ ) to collect, review, record, retain, and supply to the NASD the information required by the Rule as reproposed. We therefore estimate the total annual burden hours for the first broker-dealers to be 7,056 hours ( $3,024 + 4,032$ ).

The Rule also would require an annual review for broker-dealers

<sup>104</sup> We recognize that there may be covered OTC securities quoted in other quotation mediums, but at this time we do not have the empirical data to include them in our estimations.

<sup>105</sup> This estimate is based on the assumption that the NASD will, in the first year after the reproposal becomes effective, approve 10% fewer Form 211 filings than the 1,400 applications approved in 1998.

publishing priced quotations for covered OTC securities. We have estimated that each issuer is quoted by about 4.3 broker-dealers. We are assuming that of the universe of approximately 8,865 potentially affected covered OTC securities, broker-dealers would publish priced quotations for approximately 90% of the OTC Bulletin Board securities or 5,366 securities  $((6,625 \times 90\%) \times 90\%)$  and for 10% of the Pink Sheet securities or 290 securities  $(3,225 \times 90\%) \times 10\%$ .<sup>106</sup> Therefore, we estimate that priced quotations will be published for approximately 5,656  $(5,366 + 290)$  covered OTC securities. Given that about 60% of OTC stocks are issued by reporting issuers and the other 40% by non-reporting issuers, and that it would take a broker-dealer 4 and 8 hours, respectively, to meet the requirements of the repropoed Rule for these issuers, we estimate the burden hours as follows: for reporting issuers we estimate approximately 58,375 hours  $(3,394 \times 4.3 \times 4)$ , and for non-reporting issuers we estimate approximately 77,847 hours  $(2,263 \times 4.3 \times 8)$ . Therefore, we estimate the total annual paperwork burden hours for all broker-dealers to be 143,278 hours  $(7,056 + 58,375 + 77,847)$ .

## 2. Burden-Hours for Issuers

Regarding the burden on issuers to provide broker-dealers with the required information, we believe that the 5,319 issuers of covered OTC securities (based on our estimate that 60% of the 8,865 potentially covered OTC securities are reporting issuers) will not bear any additional hourly burdens under the amendments because these issuers already report the required information to the Commission through mandated periodic filings. Further, reporting issuer information is widely available to broker-dealers through a variety of media. However, non-reporting issuer information is not widely available. Consequently, these issuers must provide the information required by the amendments to requesting broker-dealers before quotations in their securities can be published. We believe that the 3,546 issuers of non-reporting covered OTC securities (based on an estimate that 40% of the 8,865 potentially covered OTC securities are non-reporting) will spend an average of 9 hours each to collect, prepare, and supply the information required by the proposals to the first broker-dealer that requests this information. Thereafter, we estimate that it will take an average of

1 hour for an issuer to provide the same information to the remaining 3.3 broker-dealers that request the information. Accordingly, we estimate the 3,546 non-reporting issuers annually will incur 31,914 hours  $(3,546 \times 9 \times 1)$  to comply with the first broker-dealer's request for information, and 11,702 hours  $(3,546 \times 1 \times 3.3)$  to comply with the subsequent 3.3 broker-dealer requests for an annual total of 43,616 burden hours  $(31,914 + 11,702)$ . On average, therefore, each non-reporting issuer would spend approximately 12.3 burden hours  $(43,616 / 3,546)$  per year to comply with these requests.

## 3. Total Burden-Hour Costs to Broker-Dealers and Issuers

We estimate the collection of information will require approximately 186,894 burden hours annually  $(143,278 + 43,616)$  from approximately 3,946 respondents (400 broker-dealers and 3,546 issuers).

## 4. Capital Cost to Broker-Dealers and Issuers

We believe that broker-dealers that now collect, review, and retain the information required by the current Rule will not incur any significant start-up costs to expand systems already in place. Further, broker-dealers that are collecting the information required by the proposals for other purposes also will not incur significant start-up costs. However, we believe some broker-dealers may not have adequate systems in place to retain issuer information and will incur start-up costs in order to comply with the requirements of the amendments. We assume that of the 400 broker-dealers that provide quotations for covered OTC securities, about 100 broker-dealers will incur additional start-up costs, while the remaining 300 broker-dealers will only incur incremental costs. Because the information for reporting issuers will be generally available on EDGAR and such availability satisfies the recordkeeping requirements of the proposals, we are assuming that the start-up costs associated with retaining information on reporting issuers will average \$1,000 per broker-dealer, whereas the same costs will be \$4,000 per broker-dealer for non-reporting issuer information. We estimate that broker-dealers in the aggregate will incur start-up, operating, and maintenance costs of \$100,000  $(\$1,000 \times 100)$  associated with reporting issuer information, and \$400,000  $(\$4,000 \times 100)$  associated with non-reporting issuer information. Total start-up, operating and maintenance cost burden for broker-dealers is estimated to

be \$500,000  $(\$100,000 + \$400,000)$  or an average of \$5,000 for each broker-dealer.

We assume that non-reporting issuers, because they maintain their financial information in compliance with prevailing accounting standards, will not incur any start-up costs to prepare the required information in response to broker-dealers' requests. We also believe that reporting issuers of covered OTC securities will not incur start-up costs as a result of the amendments since such issuers already provide the required information to the Commission under the federal securities laws. Therefore, we believe issuers will not incur start-up costs as a consequence of the adoption of the Rule amendments, as repropoed.

## E. General Information About the Collection of Information

The collection of information under the amendments is mandatory and would be required at periodic intervals: by the first broker-dealer to publish any quote for a covered OTC security, by broker-dealers publishing priced quotes thereafter, and by broker-dealers publishing priced quotes at the time of the annual review requirement. Broker-dealers would be required to retain the information they collect for a period of not less than three years. Information collected under the Rule would not be kept confidential. Any agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

## F. Request for comments

Pursuant to 44 U.S.C. 3506(c)(2)(B), we are soliciting comments to:

(i) evaluate whether the repropoed collection of information is necessary for the proposed performance of the functions of the agency, including whether the information will have practical utility;

(ii) evaluate the accuracy of our estimates of the burden of the repropoed collection of information;

(iii) enhance the quality, utility, and clarity of the information to be collected; and

(iv) minimize the burden of collection of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology. We seek data about quotations for covered OTC securities in OTC quotation mediums other than the OTC Bulletin Board and the Pink Sheets. We seek comments on our estimate of the number of issuers affected by the repropoed Rule and on the time estimates made for broker-dealers and

<sup>106</sup> Some securities have priced quotations published in both of these quotation systems. To avoid double counting, such securities are counted as OTC Bulletin Board securities.

issuers to comply with the information collection requirements.

Persons desiring to submit comments on the collection of information requirements should direct them to the Office of Management and Budget, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Room 10102, New Executive Office Building, Washington, DC 20503, and should also send a copy of their comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549, and refer to File No. S7-5-99. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication of this release in the **Federal Register**, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of this publication.

#### **IX. Statutory Basis and Text of Proposed Amendments and Rule**

The rule amendments are being proposed pursuant to Sections 3, 10(b), 15(c), 15(g), 17(a), and 23(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78c, 78j(b), 78o(c), 78o(g), 78q(a), and 78w(a).

#### **List of Subjects in 17 CFR Part 240**

Broker-dealers, Fraud, Reporting and recordkeeping requirements, Securities.

#### **Text of Reproposed Rule**

In accordance with the foregoing, Title 17, chapter II, part 240 of the Code of Federal Regulations is proposed to be amended as follows:

#### **PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934**

1. The authority citation for part 240 continues to read, in part, as follows:

**Authority:** 15 U.S.C. §§ 77c, 77d, 77g, 77j, 77s, 77z-2, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll(d), 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Section 240.15c2-11 and the section heading are revised to read as follows:

#### **§ 240.15c2-11 Publication or submission of quotations without current information.**

**Preliminary Note:** As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, this section prevents a broker or dealer from publishing a quotation for a security or, directly or indirectly, submitting a quotation for a

security for publication in a quotation medium, unless the broker or dealer complies with the provisions of this section or relies on an exception contained in paragraph (h) of this section. As used in this section, the term "you" refers to a broker or dealer.

(a) *When a broker or dealer must comply with this section.* You must comply with paragraph (b) of this section when you publish:

(1) The first quotation for a security;

(2) The first quotation following the termination of a Commission trading suspension ordered pursuant to section 12(k) of the Act (15 U.S.C. 78l(k)) in any security of the issuer of the suspended security;

(3) Your first quotation at a specified price for the same security after another broker or dealer publishes the first quotation for a security as described in paragraph (a)(1) or (a)(2) of this section;

(4) A quotation at a specified price for a security after a period of five or more consecutive business days when you did not publish any quotations at a specified price for that security;

(5) Your first quotation at a specified price for a security after the date that is four months after the end of the issuer's fiscal year, unless the issuer is a foreign private issuer; or

(6) Your first quotation at a specified price for a security of a foreign private issuer after the date that is seven months after the end of the issuer's fiscal year.

(b) *The steps a broker or dealer must take to comply with this section.* For each security in which you publish any of the quotations listed in paragraph (a) of this section, you must:

(1) Review the issuer information described in paragraph (c) of this section and the supplemental information described in paragraph (d) of this section;

(2) Determine that you have a reasonable basis under the circumstances for believing that the issuer information described in paragraph (c) of this section, when considered in conjunction with the supplemental information described in paragraph (d) of this section, is accurate in all material respects and was obtained from reliable sources;

(3) Make a record of:

(i) The issuer information described in paragraph (c) of this section, the supplemental information described in paragraph (d) of this section, and the sources from which you obtained the information. You will be considered to have obtained the issuer information described in paragraphs (c) or (d)(1) of this section if you obtained it through the EDGAR system, any other federal or

state electronic information system, or an electronic information system operated by an information repository, and you have the means to access the information for the period required under § 240.17a-4(b)(11);

(ii) Any significant relationship information described in paragraph (e) of this section;

(iii) The date that you reviewed the information described in paragraphs (c), (d), and (e) of this section; and

(iv) The person responsible for your compliance with the requirements of this section; and

(4) Preserve the records required to be made under paragraph (b)(3) of this section in accordance with § 240.17a-4(b)(11).

(c) *The issuer information that a broker or dealer must review.* The type of information that is considered "issuer information" and that must be reviewed under paragraph (b) of this section depends on the status of the issuer.

(1) *Issuers with a recent public offering.* If the issuer filed a registration statement under the Securities Act (other than a registration statement on Form F-6 (17 CFR 239.36)) that became effective less than 90 calendar days before you publish the quotation, and that is not the subject of a stop order, the issuer information is the prospectus specified by section 10(a) of the Securities Act (15 U.S.C. 77j(a)).

(2) *Issuers with a recent Regulation A offering.* If the issuer filed a notification under Regulation A under the Securities Act (17 CFR 230.251 through 230.263) and was authorized to commence the offering less than 40 calendar days before you publish a quotation, and the offering circular provided for under Regulation A is not the subject of a suspension order, the issuer information is the offering circular.

(3) *Certain reporting issuers.* If the issuer is current in filing annual or semi-annual reports required under section 13 or 15(d) of the Act (15 U.S.C. 78m or 78o(d)) or section 30(a) of the Investment Company Act of 1940 (15 U.S.C. 80a-29(a)), the issuer information is the issuer's most recent annual or semi-annual report and any quarterly and current reports filed by the issuer after such annual or semi-annual report. You will be considered in compliance with the requirement to obtain current reports filed by the issuer if you obtain all current reports filed by that issuer as of the date that is three business days before you publish the quotation. However, until the issuer has filed its first annual or semi-annual report, the issuer information is:

(i) The prospectus specified by section 10(a) of the Securities Act (15

U.S.C. 77j(a)) that was included in a registration statement filed by the issuer under the Securities Act and that became effective within the prior 15 months; or

(ii) The registration statement filed by the issuer under section 12 of the Act (15 U.S.C. 78l) that became effective within the prior 15 months (other than a registration statement on Form F-6 (17 CFR 239.36)), and any quarterly and current reports filed by the issuer after the registration statement became effective.

(4) *Certain financial institutions.* If the issuer is not required to file reports under sections 13 or 15(d) of the Act and is a bank or savings association, as those terms are defined in 12 U.S.C. 1813, the issuer information is the issuer's most recent annual report and any subsequent reports filed with the issuer's appropriate Federal banking agency or State bank supervisor, as those terms are defined in 12 U.S.C. 1813.

(5) *Certain exempted insurance companies.* If the issuer is exempt from section 12(g) of the Act (15 U.S.C. 78l(g)) by complying with section 12(g)(2)(G) of the Act (15 U.S.C. 78l(g)(2)(G)), the issuer information is the issuer's most recent annual statement referred to in section 12(g)(2)(G)(i) of the Act (15 U.S.C. 78l(g)(2)(G)(i)).

(6) *Other issuers.* If the issuer is not covered by paragraphs (c)(1) through (c)(5) of this section, the issuer information is the information listed below in paragraphs (c)(6)(i) through (c)(6)(xiii) of this section. Except as specified in paragraph (c)(6)(xiii) of this section, this information is presumed to be current if it is as of a date within 12 months before you publish the quotation and must be the most current information that you know or have reason to know is available:

(i) The exact name of the issuer and any predecessor;

(ii) The address and telephone number of the issuer's principal executive offices;

(iii) The state of incorporation of the issuer, if it is a corporation;

(iv) The date on which the issuer's fiscal year ends;

(v) For each class of the issuer's securities outstanding:

(A) The exact title of the security;

(B) The par or stated value of the security;

(C) The number of securities or total principal amount outstanding of the security;

(D) The class and number of securities issuable upon the security's exercise, exchange or conversion, if applicable; and

(E) The total number of securityholders of record for the security as of the end of the issuer's most recent fiscal year or a more recent date;

(vi) The exact title and class of the security to be quoted;

(vii) The name, address and telephone number of the transfer agent;

(viii) A description of the issuer's business and facilities;

(ix) A description of the issuer's products or services;

(x) The full names and business addresses of the executive officers, directors, general partners, promoters, and control persons of the issuer, and the number of securities of each class of the issuer's securities that are beneficially owned by each such person as of the end of the issuer's last fiscal year or a more recent date;

(xi) The following information:

(A) A description of any of the following actions to which any executive officer, director, general partner, promoter, or control person of the issuer has been the subject during the prior five years:

(1) A conviction in a criminal proceeding or named as a defendant in a pending criminal proceeding (excluding traffic violations and other minor offenses);

(2) The entry of an order, judgment, or decree, not subsequently reversed, suspended or vacated, by a court of competent jurisdiction that permanently or temporarily enjoins, bars, suspends or otherwise limits involvement in any type of business, securities, commodities, or banking activities;

(3) A finding or judgment by a court of competent jurisdiction (in a civil action), the Commission, the Commodity Futures Trading Commission, or a state securities regulator of a violation of federal or state securities or commodities law, which has not been reversed, suspended, or vacated; and

(4) The entry of an order by a self-regulatory organization that permanently or temporarily bars, suspends or otherwise limits involvement in any type of business or securities activities; or

(B) A statement from the issuer that no executive officer, director, general partner, promoter, or control person of the issuer is the subject of any of the actions listed in paragraphs (c)(6)(xi)(A)(1) through (4) of this section; or

(C) A description of the steps you have taken to obtain from the issuer the information needed to comply with paragraphs (c)(6)(xi)(A) or (c)(6)(xi)(B) of this section and a statement that the

issuer failed or refused to provide this information;

(xii) The following information:

(A) A description of any of the following events involving the issuer, its predecessor, or any of its majority-owned subsidiaries that occurred in the prior two years:

(1) A change in control;

(2) An increase of 10% or more of the same class of outstanding equity securities;

(3) A merger, acquisition, or business combination;

(4) An acquisition or disposition of significant assets;

(5) A bankruptcy proceeding; and

(6) The delisting of securities by any securities exchange or Nasdaq; or

(B) A statement from the issuer that the issuer, its predecessor, and its majority-owned subsidiaries have not been the subject of any of the actions or events listed in paragraphs (c)(6)(xii)(A)(1) through (6) of this section; or

(C) A description of the steps you have taken to obtain from the issuer the information needed to comply with paragraphs (c)(6)(xii)(A) or (c)(6)(xii)(B) of this section and that the issuer failed or refused to provide this information; and

(xiii) The financial information listed below in paragraphs (c)(6)(xiii)(A) or (c)(6)(xiii)(B) and (c)(6)(xiii)(C) of this section:

(A) If the issuer is not a foreign private issuer, the issuer's most recent balance sheet, statement of cash flows, statement of comprehensive income, and statement of operations (income), prepared in accordance with U.S. generally accepted accounting principles. Unless you know or have reason to know that more current information is available, this information will be presumed to be current if:

(1) The balance sheet is as of a date that is less than 15 months before you publish the quotation;

(2) The statement of cash flows, statement of comprehensive income, and statement of operations (income) are for the 12 months preceding the date of such balance sheet; and

(3) If the balance sheet is as of a date that is more than 6 months before you publish the quotation, it must be accompanied by an additional statement of cash flows, statement of comprehensive income, and statement of operations (income) for the period from the date of such balance sheet to a date that is less than 6 months before you publish the quotation.

(B) If the issuer is a foreign private issuer, the issuer's most recent balance

sheet and statement of operations (income), and to the extent prepared by the issuer, statement of cash flows, statement of comprehensive income, and statement of changes in shareholders' equity, prepared in accordance with a comprehensive body of accounting principles. Unless you know or have reason to know that more current information is available, this information will be considered current if:

(1) The balance sheet is as of a date that is less than 18 months before you publish the quotation;

(2) The statement of cash flows, statement of comprehensive income, statement of operations (income), and statement of changes in shareholders' equity are for the 12 months preceding the date of such balance sheet; and

(3) If the balance sheet is as of a date that is more than 9 months before you publish the quotation, it must be accompanied by an additional statement of cash flows, statement of comprehensive income, statement of operations (income), and statement of changes in shareholders' equity for the period from the date of such balance sheet until a date that is less than 9 months before you publish the quotation, if any such statements have been prepared by the issuer.

(C) The same financial information required by paragraph (c)(6)(xiii)(A) and (B) of this section for such part of the two preceding fiscal years as the issuer or any predecessor has been in existence (one year with respect to the balance sheet), prepared in accordance with U.S. generally accepted accounting principles (or prepared in accordance with a comprehensive body of accounting principles in the case of a foreign private issuer). However, if the issuer has emerged from reorganization pursuant to Chapter 11 of the Bankruptcy Code (11 U.S.C. 1101 *et seq.*) and the reorganization plan has been in effect less than two years, the financial information required under this paragraph (c)(6)(xiii) is the court-approved disclosure statement filed under 11 U.S.C. 1125 and the financial information described in this paragraph (c)(6)(xiii) from the date of the entry of the bankruptcy court order confirming the issuer's reorganization plan pursuant to 11 U.S.C. 1129.

(d) *The supplemental information that a broker or dealer must review.* The type of information that is considered "supplemental information" and that you must review under paragraph (b) of this section is the following:

(1) A copy of any trading suspension order issued by the Commission under section 12(k) of the Act (15 U.S.C.

78l(k)) for any securities of the issuer or its predecessor (if any) during the 12 months before you publish the quotation, or a copy of the public release issued by the Commission announcing such trading suspension order; and

(2) A copy or a written record of any other material information (including adverse information) about the issuer that comes to your knowledge or possession before you publish a quotation.

(e) *The significant relationship information that the broker or dealer must make and keep a record of.* The type of information that is considered "significant relationship" information and that you must make and keep a record of under paragraph (b) of this section is the following:

(1) Any direct or indirect affiliation between the issuer and you or between the issuer and any of your associated persons;

(2) Whether you are publishing the quotation on behalf of any other broker or dealer, or any of its associated persons, and, if so, the name of such broker or dealer, or the associated person, and the terms of the arrangement;

(3) Whether you have received, or have any arrangement to receive, any monetary or other consideration from any person for publishing the quotation and, if so, a description of the consideration and the name of the person providing the consideration; and

(4) Whether you are publishing the quotation directly or indirectly on behalf of the issuer, or any executive officer, director, general partner, promoter, control person, or any person, who is directly or indirectly the beneficial owner of more than 10 percent of the outstanding units or shares of any equity security of the issuer, and, if so, the name of such person, and the basis for any exemption under the federal securities laws for any sales of such securities on behalf of such person.

(f) *The information a broker or dealer must submit to the NASD.* At least three business days before you publish a quotation covered by paragraph (a) of this section, you must submit to the NASD, in accordance with NASD rules, the information required in paragraphs (c), (d), and (e) of this section.

(g) *The broker or dealer must make certain information required by this section available upon request.*

(1) If you publish a quotation for a security in compliance with this section, you must make the issuer, supplemental, and significant relationship information specified in

paragraphs (c)(5), (c)(6), (d), and (e) of this section promptly available upon request to any customer, prospective customer, other broker or dealer, or information repository. By providing this information to others under this paragraph (g), you do not represent that the information is accurate; rather, you represent that, as of the date recorded under paragraph (b)(3)(iii) of this section, you had a reasonable basis under the circumstances for believing that the information was accurate and current in all material respects and was obtained from reliable sources; but

(2) You do not need to comply with paragraph (g)(1) of this section to the extent that the information is reasonably available through EDGAR, any other federal or state electronic information system, or an information repository.

(h) *When a broker or dealer is not required to comply with this section.* You are not required to comply with this section when you publish a quotation for:

(1) A security that is listed on a national securities exchange or Nasdaq; is traded on such exchange or Nasdaq on the same day as, or on the business day immediately before, the day you publish the quotation; and is not suspended, terminated, or prohibited from trading on such exchange or Nasdaq;

(2) An exempted security, as defined in section 3(a)(12) of the Act (15 U.S.C. 78c(a)(12));

(3) A security where the quotation represents the unsolicited order of a customer (other than a person acting as or for a dealer);

(4) A non-convertible debt security or a non-participatory preferred stock;

(5) An asset-backed security that is rated by at least one nationally recognized statistical rating organization, as that term is used in § 240.15c3-1, in one of its generic rating categories that signifies investment grade;

(6) A security with a worldwide average daily trading volume value of at least \$100,000 during each month of the six full calendar months immediately before the date you publish the quotation;

(7) A convertible security, if the underlying security meets the requirements of paragraph (h)(6) of this section;

(8) A security that has bid price, as published on a national securities exchange, Nasdaq, or quotation medium, of at least \$50 per share. If the security is a unit composed of one or more securities, the bid price of the unit divided by the number of shares of the unit that are not warrants, options,

rights, or similar securities must be at least \$50; or

(9) A security of an issuer that has net tangible assets in excess of \$10,000,000.

(i) *The steps to take to become an information repository.*

(1) An entity seeking information repository designation must file an application with the Director of the Commission's Division of Market Regulation in Washington, DC. The application should provide detailed information explaining how the entity satisfies the attributes set forth in paragraph (i)(2) of this section. The entity must also file any additional information relating to the attributes set forth in paragraph (i)(2) of this section that the Director of the Commission's Division of Market Regulation subsequently requests;

(2) In determining whether to designate an entity as an information repository, the Commission will consider whether the entity:

- (i) Collects information about a substantial segment of issuers of securities subject to this section;
- (ii) Maintains current and accurate information about such issuers;
- (iii) Has effective acquisition, retrieval, and dissemination systems;
- (iv) Places no inappropriate limits on the issuers from or about which it will accept information;
- (v) Provides access to the documents deposited with it to anyone willing and able to pay the applicable fees;
- (vi) Charges reasonable fees; and
- (vii) In general, is so organized and has the capacity to be able to reasonably carry out the purposes of this section.

(3) An information repository must notify the Director of the Commission's Division of Market Regulation of any material changes that occur in the facts and circumstances of its application for such designation; and

(4) In the event it is determined that an information repository no longer satisfies all of the attributes set forth in paragraph (i)(2) of this section, the Director of the Commission's Division of Market Regulation may revoke such designation.

(j) *The definitions applicable to this section.* For purposes of this section, the following definitions apply:

(1) *Alternative trading system* has the same meaning contained in § 242.300(a) of this chapter.

(2) *Asset backed security* has the meaning contained in General Instruction I.B.5. to Form S-3 (17 CFR 239.13).

(3) *Information repository* means an entity that:

- (i) Gathers and provides to brokers or dealers and others current issuer

information described in paragraph (c) of this section when this information is not routinely or widely made available, electronically or otherwise; and

(ii) Is designated by the Commission as an information repository as described in paragraph (i) of this section.

(4) *Issuer*, in the case of quotations for American Depositary Receipts, means the issuer of the deposited shares represented by such American Depositary Receipts.

(5) *NASD* means the National Association of Securities Dealers, Inc., and its wholly owned subsidiaries (including, but not limited to, NASD Regulation, Inc. and The Nasdaq Stock Market, Inc.).

(6) *Nasdaq* means The Nasdaq National Market and The Nasdaq SmallCap Market, both operated by The Nasdaq Stock Market, Inc.

(7) *Net tangible assets* means total assets less intangible assets and liabilities. For purposes of this section, net tangible assets must be demonstrated by current financial statements, as described in paragraph (c)(6)(xiii) of this section, and:

(i) If the issuer is not a foreign private issuer, the financial statements must be audited and reported on by an independent public accountant in accordance with § 210.2-02 of this chapter; or

(ii) If the issuer is a foreign private issuer, the financial statements must be prepared in accordance with a comprehensive body of accounting principles, audited in compliance with requirements of the country of incorporation, and reported on by an accountant duly registered and in good standing in accordance with the regulations of that jurisdiction.

(8) *Non-participatory preferred stock* means non-convertible capital stock, the holders of which are entitled to a preference in payment of dividends and in distribution of assets on liquidation, dissolution, or winding up of the issuer, but are not entitled to participate in residual earnings or assets of the issuer.

(9) *Promoter* has the same meaning contained in § 230.405 of this chapter.

(10) *Publish* means to publish a quotation for a security in a quotation medium or, directly or indirectly, to submit a quotation for a security for publication in a quotation medium.

(11) *Quotation* means any bid or offer at a specified price with respect to a security, or any indication of interest by a broker or dealer in receiving bids or offers from others for a security, or any indication by a broker or dealer that advertises its general interest in buying or selling a particular security.

(12) *Quotation medium* means any:

(i) System of general circulation to brokers or dealers that regularly disseminates quotations of identified brokers or dealers; or

(ii) Publication, alternative trading system, or other device that is used by brokers or dealers to disseminate quotations to others.

(13) *Securities Act* means the Securities Act of 1933 (15 U.S.C. 77a et seq.).

(k) *How this section applies to securities for which a broker or dealer is publishing quotations immediately before the effective date of the amendments.* If you were publishing a quotation for a security on the business day immediately before April 7, 1999, you may continue to publish quotations for the security without complying with paragraph (b) of this section until you publish a quotation described in paragraphs (a)(2), (a)(3), (a)(4), (a)(5), or (a)(6) of this section.

(l) *The Commission can grant exemptions from this section.* This section does not prohibit the publication of any quotation for a security or a class of securities, if the Commission, on written request or its own motion, exempts such quotation, either unconditionally or on specified terms and conditions.

3. Section 240.17a-4 is amended by adding paragraph (b)(11) to read as follows:

**§ 240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.**

\* \* \* \* \*

(b) \* \* \*

(11) The records required to be obtained pursuant to § 240.15c2-11.

\* \* \* \* \*

Dated: February 25, 1999.

By the Commission.

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

**Note:** This Appendix to the Preamble will not appear in the Code of Federal Regulations.

## Appendix

### Guidance on the Scope of a Broker-Dealer's Review Under Current Rule 15c2-11 and the Amendments

#### I. Introduction

To assist broker-dealers in complying with Rule 15c2-11 (Rule) <sup>1</sup> under the Securities Exchange Act of 1934 (Exchange Act),<sup>2</sup> we are setting forth the factors that they should consider in carrying out their review obligations

<sup>1</sup> 17 CFR 240.15c2-11.

<sup>2</sup> 15 U.S.C. 78a et seq.



under the Rule as it currently exists and under the amendments proposed in Securities Exchange Act Release No. 34-41110.<sup>3</sup> We are providing this guidance because commenters on the initial proposal<sup>4</sup> expressed concerns about their review obligations under its provisions, particularly in light of elimination of the piggyback provision, the addition of an annual review requirement, and the obligation to obtain enhanced issuer information. This guidance applies, unless otherwise noted, to a broker-dealer's obligations under the current Rule as well as under the reproposal.

Rule 15c2-11 regulates the publication of quotations for OTC securities in a quotation medium.<sup>5</sup> The Rule generally prohibits broker-dealers from publishing a quotation unless they have reviewed specified information about the issuer. The kind of information depends on the nature of the issuer, e.g., whether the issuer is subject to the Exchange Act's periodic reporting requirements (reporting issuer) or is an issuer that is not subject to the Exchange Act's reporting requirements (non-reporting issuer). Broker-dealers must also have a reasonable basis for believing that the issuer information, when considered in conjunction with any supplemental information,<sup>6</sup> is accurate in all material respects and that it was obtained from a reliable source.

The Rule is precise about the kind of issuer and other information that the broker-dealer must obtain and review before publishing quotations and about how current that information must be. However, some commenters on the Proposing Release stated that they were unclear about the nature of the broker-dealer's obligation to determine that the broker-dealer reasonably believes that the source of the Rule 15c2-11 information is reliable and that the information is accurate

in all material respects. We are giving our views on the steps a broker-dealer should take to assess the reliability of the source of the required information and the accuracy of that information.<sup>7</sup>

## II. Quotation Events Triggering the Review Requirement

Under the current Rule, the first broker-dealer to publish a priced quotation must obtain and review the Rule's required information. Under the current Rule's piggyback exception, a broker-dealer does not have to satisfy these information requirements when it publishes a quotation for a security if it, or any other broker-dealer, is already publishing regular quotations for the security.<sup>8</sup> This means that the first market maker publishing a quotation is the only one that has to obtain the required information, and thereafter, any other market maker can publish quotations in the security indefinitely, unless there is a significant lapse in quotation activity.<sup>9</sup>

The amendments will restructure Rule 15c2-11 by setting forth more clearly the quotation events that trigger the Rule, the requirements that the broker-dealer must satisfy, and the nature of the information that the broker-dealer must review. The amendments state that no broker-dealer, directly or indirectly, may publish the described kinds of quotations for a security in any quotation medium, without first complying with the Rule's provisions.<sup>10</sup> Under the amendments, the Rule will apply at specified points in time, namely, when a broker-dealer publishes:

- the first quotation for a security;
- its first quotation at a specified price for a security after another broker or dealer published the first quotation for the same security.
- the first quotation following the termination of a Commission trading

<sup>7</sup> This discussion confirms and supplements earlier guidance on Rule 15c2-11 issues. See Securities Exchange Act Release No. 29094 (April 17, 1991), 56 FR 19148 (1991 Adopting Release); Securities Exchange Act Release No. 27247 (September 14, 1989), 54 FR 39194 (1989 Proposing Release).

<sup>8</sup> 17 CFR 240.15c2-11(f)(3). The security must have been the subject of quotations on at least 12 business days during the previous 30 calendar days, with no more than 4 consecutive business days elapsing without a quotation. Effectively, the Rule applies only to those market makers publishing quotations during the first 30 days of a security's trading. The ability to piggyback on one's own quotations is referred to as "self-piggybacking."

<sup>9</sup> The piggyback exception would be eliminated under the proposed amendments.

<sup>10</sup> The current Rule applies to an *interdealer quotation system*, which is a quotation medium of general circulation to brokers or dealers which regularly disseminates quotations of identified brokers or dealers. 17 CFR 240.15c2-11(e)(2). Under the proposed amendments, the definition of "interdealer quotation system" would be incorporated into the definition of "quotation medium." Under the amendments, a "quotation medium" will be a system of general circulation to brokers or dealers that regularly disseminates quotations of identified brokers or dealers; or publication, alternative trading system, or other device that is used by brokers or dealers to disseminate quotations to others.]

suspension ordered pursuant to section 12(k) of the Exchange Act<sup>11</sup> in any security of the issuer of the suspended security;

- a quotation at a specified price for a security after a period of five or more consecutive business days when it did not publish any quotations at a specified price for that security;
- its first quotation at a specified price for a security after the date that is four months after the end of the issuer's fiscal year, unless the issuer is a foreign private issuer; or
- its first quotation at a specified price for a security of a foreign private issuer after the date that is seven months after the end of the issuer's fiscal year.

If the Rule applies, under both the current Rule and the amendments, the broker-dealer must:

- review the Rule's specified information;
- determine that it has a reasonable basis for believing that the information is accurate in all material respects and was obtained from reliable sources;
- Record the date it reviewed the specified information, the sources of the information, and the person at the firm responsible for the broker-dealer's compliance with the Rule; and
- Preserve the specified information in accordance with Rule 17a-4.<sup>12</sup>

We set out below in more detail the review obligation required of a broker-dealer before it publishes a quotation for covered OTC securities. In general, the broker-dealer must first form a reasonable belief about the source's reliability. Then the broker-dealer should examine the materials to make sure it has obtained all of the information required by the Rule, including any supplemental information known by the broker-dealer. In reviewing this information, the Rule requires that the broker-dealer must have a reasonable basis under the circumstances for believing that the issuer information described in paragraph (a) [reproposed paragraph (c)] of the Rule,<sup>13</sup> when considered in conjunction with the supplemental information described in paragraph (b) [reproposed paragraph (d)] of the Rule,<sup>14</sup> is accurate in all material

<sup>11</sup> 15 U.S.C. 78l(k).

<sup>12</sup> 17 CFR 240.17a-4.

<sup>13</sup> Currently, a broker-dealer must review and maintain in its records certain issuer information, which, depending on the issuer, may include prospectuses or offering circulars; certain Exchange Act reports; other regulatory filings; information furnished to the Commission pursuant to Section 12(g)(2)(G)(i) of the Exchange Act; or certain financial information for non-reporting issuers. The amendments expand the information required for issuers that do not file periodic reports with the Commission (e.g., non-reporting issuers). In addition, broker-dealers would be required to make the issuer information available to anyone who requested it.

<sup>14</sup> In addition to a copy of any trading suspension order issued by the Commission pursuant to Exchange Act Section 12(k), the broker-dealer must record and consider any other material information (including adverse information) regarding the issuer that comes to its knowledge or possession before publishing a quotation under the Rule. Paragraph (b) [reproposed paragraph (d)] does not require a broker-dealer to maintain trivial information or information from an uncertain source. Also, the

<sup>3</sup> This appendix sets forth guidance on a broker-dealer's review obligations under the Rule as it currently exists and under the proposed amendments. If the Commission takes final action on the proposed amendments, the Appendix will be revised to delete references to the proposal and to reflect the final rule. We expect that the Appendix will provide useful guidance to broker-dealers in conducting the document review required by the Rule.

<sup>4</sup> Securities Exchange Act Release No. 39670 (February 17, 1998), 63 FR 9661 (Proposing Release).

<sup>5</sup> A quotation is broadly defined as any indication that a broker-dealer is willing to buy or sell a particular security. The repropoed Rule, however, applies most directly to priced quotations. Rule 15c2-11 applies to broker-dealers that publish quotations for securities traded in the OTC markets. In this appendix, "OTC stocks" or "OTC securities" refers to securities that are not listed on a national securities exchange or Nasdaq. "Covered OTC securities" refers to those OTC securities that are subject to Rule 15c2-11. Rule 15c2-11 applies to securities quoted on the OTC Bulletin Board, operated by the National Association of Securities Dealers, Inc. (NASD); the Pink Sheets operated by the National Quotation Bureau, Inc. (NQB); and similar quotation systems.

<sup>6</sup> See footnote 14 below for a description of "supplemental information."

respects and was obtained from reliable sources.

In addition, we are providing numerous examples of "red flags" often associated with Rule 15c2-11 documents. A red flag is information that under the circumstances signals that one or more of the required items of information may be materially inaccurate. We consider these red flags to be indications that should lead a broker-dealer to inquire whether it had a reasonable basis to believe that the issuer information is accurate in all material respects and that it was obtained from a reliable source.

The red flags that we discuss have been present in Commission enforcement actions, examinations conducted by our staff, and reviews of Rule 15c2-11 conducted by the National Association of Securities Dealers, Inc. (NASD) submissions, but our discussion is not meant to be exhaustive. Other information may come into the broker-dealer's knowledge or possession that would lead it to question whether the source is reliable or whether the required information is accurate in all material respects. The adequacy of a broker-dealer's review must be considered on a case-by-case basis.

The repropoed Rule would require a broker-dealer to obtain and review some issuer information not required by the current Rule, such as criminal or securities law violations and additional issuer information. Until the proposal is adopted, the Rule does not require the broker-dealer to obtain and review this information. This information, however, would be a red flag and, under the current Rule, could be "material information" that the broker-dealer must take into account when conducting its review obligations.

### III. The Review Process

#### A. Introduction

While the broker-dealer must obtain and review the required information, the standard of review is based on a broker-dealer's arriving at a reasonable belief, not a certainty, that the information is accurate and was obtained from a reliable source. Although broker-dealers often refer to their Rule 15c2-11 files as "due diligence" files, the Rule's standard of review does not approach the depth of inquiry generally associated with an underwriter's obligations in a registered public offering or with a retail broker's obligations in recommending a security to a customer. As discussed below, the scope of review is relatively simple in the case of an issuer that has just completed a public offering or an offering under Regulation A<sup>15</sup> or that files periodic reports with the Commission.<sup>16</sup> In these cases, the broker-

broker-dealer is not required to affirmatively seek out information about the issuer beyond that specifically required by the Rule. However, if material information about the issuer comes to its knowledge or possession (orally or in writing), the broker-dealer must take that information into account in assessing whether the issuer information is accurate and is from a reliable source. See footnote 35 below regarding how to obtain information about Commission trading suspensions.

<sup>15</sup> 17 CFR 230.251-230.263.

<sup>16</sup> Under the reproposal, the broker-dealer can look to filings made with other federal or state

dealer must obtain and review information that is on file with the Commission, in addition to any supplemental information. In the case of a non-reporting issuer, where there may be no information filed with a regulatory authority, the broker-dealer must obtain the required information from sources it deems reliable and must review this information together with any supplemental information.

The Rule does not currently specify the status of the person who must conduct the review on the broker-dealer's behalf. Under the repropoed Rule, the broker-dealer must make a record of the person at the firm who is responsible for the broker-dealer's compliance with the Rule's provisions.<sup>17</sup> Generally, the person performing the review should have sufficient experience or authority at the firm to make sure that the Rule's requirements are fully satisfied.

Rule 15c2-11 is intended to prevent broker-dealers from becoming involved in the fraudulent manipulation of OTC securities. However, even if a broker-dealer technically complies with the Rule's requirements, it would be subject to liability under other antifraud provisions of the securities laws, such as Rule 10b-5, if a broker-dealer publishes quotations as part of a fraudulent or manipulative scheme.<sup>18</sup>

#### B. Source Reliability

##### 1. Determining Whether a Source is Reliable

The broker-dealer must first have a reasonable basis for believing that Rule 15c2-11 information comes from a reliable source. In general, this means that the information was derived from the issuer. If the information is from the issuer or its officers and directors, attorney, or accountant, the broker-dealer generally can assume that the source is reliable, absent red flags to the contrary.<sup>19</sup> If the information is from EDGAR or another governmental website or an independent retrieval service<sup>20</sup> or standard research sources<sup>21</sup> or an information repository contemplated under the repropoed Rule, the broker-dealer can satisfy the Rule's requirement to have a reasonable basis for believing that the source of the information is reliable. If the broker-dealer receives the information from an independent and objective source, such as a bank that is not a market maker in the security, which represents that it has prepared the information or received the information directly from the issuer, the

regulatory authorities for certain types of issuers, e.g., financial institutions.

<sup>17</sup> See text of repropoed Rule 15c2-11(b)(3)(iv).

<sup>18</sup> 17 CFR 240.10b-5.

<sup>19</sup> Because of recent microcap fraud cases involving promoters, a broker-dealer should not presume a promoter is a reliable source of issuer information. See *SEC Charges 44 Stock Promoters in First Internet Securities Fraud Sweep*, Press Release 98-117 (October 28, 1998) available at <<http://www.sec.gov/news/press/98-117.txt>>.

<sup>20</sup> Examples of an "independent retrieval service" would be the SEC's Public Reference Room or a document retrieval service.

<sup>21</sup> Examples of "standard research sources" include publications such as Standard & Poor's Standard Corporation Manual and Moody's Investors Service Manuals.

broker-dealer typically may rely on that representation as to the source. Because broker-dealers frequently obtain the Rule 15c2-11 information from these sources, the reliability of the information's source is not often called into question.

Occasionally, the broker-dealer may obtain the Rule 15c2-11 information from sources not associated with the issuer, such as another market maker.<sup>22</sup> In this case, the requesting broker-dealer should inquire about the original source of the information. The broker-dealer providing the information must make a record of the source of the issuer information and can supply this information to the requesting broker-dealer.

When a red flag regarding the source's reliability exists, the broker-dealer must inquire further to reasonably determine whether the information's source is reliable. To satisfy the Rule's requirements, the broker-dealer must ascertain the original source of the information, especially when a broker-dealer is provided information from another broker-dealer that encourages the publication of quotations rather than responds to a request for information.<sup>23</sup> If the broker-dealer providing the information refuses to substantiate that the information is from the issuer, this refusal is a red flag that may indicate that the source is unreliable. If the broker-dealer is told that the issuer has prepared or approved the information, the broker-dealer may need to verify that representation by directly contacting the issuer.

##### 2. Examples of Unreliable Sources

The Report of Investigation Regarding Transactions in the Securities of Laser Arms Corporation (Laser Arms Report) illustrates when a broker-dealer did not have a reasonable basis to believe that the information about a non-reporting issuer was from a reliable source.<sup>24</sup> The Laser Arms Report noted that "inherent in the requirement of paragraph (a)(5) [repropoed paragraph (c)(6)] is 'the premise that the broker-dealer must at least verify that it has received the required information and know that source of the information.'"<sup>25</sup>

The broker-dealer that submitted the initial application to quote Laser Arms stock did not make any attempt to verify the source of the issuer information contained in the Laser Arms Memorandum. In fact, it was a fictitious document prepared by a recidivist securities law violator who was the

<sup>22</sup> The proposed Rule will require a broker-dealer to provide the information to another broker-dealer upon request.

<sup>23</sup> See *Bunker Securities, Inc.*, 48 S.E.C. 859 (1987), *aff'd without opinion*, 833 F.2d 303 (3d Cir. 1987).

<sup>24</sup> 50 S.E.C. 489 (1991). The Laser Arms Report was issued pursuant to the investigative authority granted to the Commission under Section 21(a) of the Exchange Act (15 U.S.C. 78u(a)).

<sup>25</sup> Laser Arms Report at 501, *citing* Securities Exchange Act Release No. 34-29095 (April 17, 1991), 56 FR 19158 (1991 Proposing Release).

undisclosed principal of Laser Arms.<sup>26</sup> The broker-dealer's immediate source of the Laser Arms Memorandum was a trader at another broker-dealer whom he had known for less than one year, had seen on only a few occasions, and had dealt with primarily by telephone. The broker-dealer did not review or attempt to determine the source of any part of the information in the Laser Arms Memorandum. Any attempt to contact the issuer directly probably would have led to the discovery that Laser Arms was a shell corporation with no assets, operations, or products.<sup>27</sup> Under these circumstances, the Commission did not believe that this broker-dealer, or any of the broker-dealers to subsequently publish quotations, had a reasonable basis for believing that the source of the Rule 15c2-11 information was reliable.<sup>28</sup>

### C. Document Review Obligations

Once the broker-dealer has formed a reasonable belief about the source's reliability, it should examine the materials to make sure it has obtained all of the information required by the Rule. This means that a broker-dealer must not only review the information about the issuer of the security to be quoted but also consider any supplemental information.<sup>29</sup> The Rule requires that the broker-dealer must have a reasonable basis under the circumstances for believing that the issuer information described in paragraph (a) [reproposed paragraph (c)] of the Rule, when considered in conjunction with the supplemental information described in paragraph (b) [reproposed paragraph (d)] of the Rule, is accurate in all material respects.

Unlike the duties of an underwriter in a securities offering, Rule 15c2-11 ordinarily does not require a broker-dealer to conduct an independent inquiry about the issuer of the security to be quoted. A broker-dealer publishing quotes for a covered OTC security may have no relationship with the issuer, and the Rule does not demand that the broker-dealer develop one to obtain information. However, the broker-dealer

must review the required information, together with any supplemental information that comes to its attention, and should be alert to red flags.

Because documents filed with the Commission are subject to liability provisions, a broker-dealer generally can reach a reasonable belief as to the accuracy of information contained in these documents.<sup>30</sup> This also would be true for documents filed with financial institutions' regulatory authorities, which broker-dealers may obtain and review when publishing quotes for the securities of certain banks, provided for in paragraph (c)(4) of the reproposed Rule.

If a registration statement incorporates other documents by reference, the broker-dealer may be required to obtain some of the incorporated documents to satisfy the Rule's information gathering and review requirements. It should not be necessary for the broker-dealer to be familiar with all aspects of the filed documents. The broker-dealer should focus on those sections that describe the items of information set forth in Rule 15c2-11(a)(5) [reproposed Rule 15c2-11(c)(6)], the issuer's identified "risk factors,"<sup>31</sup> any recent material business combinations, such as the merger of a reporting shell into a non-reporting company, and current financial information.

In contrast to information from other kinds of issuers, non-reporting issuer information generally has not been filed with any regulatory authority. Thus, the broker-dealer cannot make any assumptions about the accuracy of such information. Similarly, a broker-dealer cannot make any assumptions about the accuracy of information to documents and other materials that are submitted to the Commission by foreign private issuers under Rule 12g3-2(b). Although they are submitted to the Commission, these documents are not "filed" and so are not subject to the liabilities that attach to reporting issuer information. These documents are prepared in accordance with the standards of the issuer's home jurisdiction, not the standards set forth under the U.S. federal securities laws, and broker-dealers should independently assess the accuracy of such information. Broker-dealers will also need to independently assess the accuracy of information filed with foreign securities regulatory authorities, based on considerations such as the disclosure and liability standards under foreign law. In

reviewing the Rule's required information for non-reporting issuers, the kinds of significant events that require a domestic reporting issuer to file a Form 8-K under the Exchange Act<sup>32</sup> also should be considered red flag events.

Where no red flags appear during the review of current and complete information, the broker-dealer would have a reasonable basis for believing that the Rule's information is accurate. At this point, the broker-dealer's review ordinarily would end, *i.e.*, the broker-dealer would not be required to question the financial statements or any other information required to be obtained and reviewed. The Rule does not require the broker-dealer to question any information unless the information contains apparent material discrepancies, or other information in the broker-dealer's knowledge or possession (*i.e.*, paragraph (b) [reproposed paragraph (d)] information) reasonably indicates that the paragraph (a) [reproposed paragraph (c)] information is materially inaccurate.

When red flags are present, the broker-dealer's efforts to satisfy itself with respect to the accuracy of the information will vary with the circumstances and may require the broker-dealer to obtain additional information or seek to verify existing information. If the broker-dealer is aware that the required issuer information is materially inaccurate, it may nevertheless publish quotations without violating the Rule, as long as the broker-dealer can supplement that information with additional information that the broker-dealer reasonably believes is accurate. If the immediate source of the issuer information is unreliable, however, the broker-dealer should view that source with skepticism and attempt to obtain the Rule's information from another source. For example, a broker-dealer that is aware that the required issuer information is inaccurate could produce a written record reflecting the additional, corrected information or could obtain other materials, such as a more recent Form 8-K,<sup>33</sup> that would permit the broker-dealer to comply with the Rule. If the broker-dealer sees that the auditor's report in an issuer's financial statements is qualified, the broker-dealer may need to contact the accountants about the basis for such qualification. If the broker-dealer learns that an issuer's control person has been convicted of securities fraud, it should contact the appropriate regulatory authority to ascertain the facts.<sup>34</sup>

The Rule's provisions are triggered by discrete quotation events. Once the broker-dealer has complied with the Rule's requirements with respect to a particular quotation event, there is no continuing duty to obtain and review the information. Of course, when a quotation event occurs, *e.g.*, the broker-dealer is publishing priced quotations as of the annual review date

<sup>26</sup> The Laser Arms Memorandum misrepresented Laser Arms as a high technology weapons manufacturer and the developer of a self-chilling beverage can. The memorandum also included forged certificates of incorporation, fictitious balance sheets, and auditor's report which the signature of the accountant had been forged.

<sup>27</sup> Another broker-dealer who attempted to call Laser Arms learned there was no telephone listing for the company. This broker-dealer nevertheless initiated a market in Laser Arms' securities.

<sup>28</sup> See also *Bunker Securities, Inc.*, 48 S.E.C. 859 (1987, *aff'd without opinion*, 833 F.2d 303 (3d Cir. 1987).

<sup>29</sup> See footnote 14 above for a definition of supplemental information.

<sup>30</sup> See Sections 11 and 27 of the Securities Act, 15 U.S.C. 77k and 77x, and Sections 18 and 32 of the Exchange Act, 15 U.S.C. 78r and 78ff. See 1991 Adopting Release, 56 FR 19148, 19150 (1991).

<sup>31</sup> If the issuer's registration statement, pursuant to Item 401 of Regulation S-K, describes criminal or other disciplinary proceedings involving a reporting issuer's officer, director, general partner, promoter, or control person, this would be a red flag. Reproposed Rule 15c2-11(c)(6)(xi) will require broker-dealers to inquire about these types of criminal or other disciplinary proceedings involving a non-reporting issuer's office, director, general partner, promoter, or control person. Under the current Rule, however, a broker-dealer's knowledge of criminal or other disciplinary proceedings involving a reporting or non-reporting issuer's officer, director, general partner, promoter, or control person would be a red flag.

<sup>32</sup> 17 CFR 249.308.

<sup>33</sup> 27 CFR 249.308.

<sup>34</sup> Even though the criminal and securities law violations specified in reproposed paragraph (c)(6)(xi) are not specified in paragraph (a)(5) of the current Rule, a broker-dealer's knowledge of such information would be material adverse information under the current rule, and such violations would be a red flag.

required by the reproposed Rule, it must conduct a review of current issuer information. In this case, the review process would be the same as described above. However, the review process should be somewhat simpler because the broker-dealer would already have gained some familiarity with the issuer as a result of its prior review.

#### *D. Scope of Review Following a Trading Suspension*

A Commission trading suspension is a material event affecting the market for an issuer's securities.<sup>35</sup> After the termination of a trading suspension, a broker-dealer may not enter a quotation unless and until it has strictly complied with all the provisions of the Rule. Before initiating or resuming a quotation for securities subject to Rule 15c2-11, the broker-dealer must conduct a careful review in a professional manner of the basis for the trading suspension to determine whether there is a reasonable basis for the broker-dealer to believe that the information about the issuer is accurate and current. The broker-dealer may be unable to reach a reasonable basis for relying on the questioned financial statements in the Commission's order even if the information otherwise satisfies the Rule's presumption of "current" information.<sup>36</sup> This presumption is obviated if the broker-dealer has information to the contrary.<sup>37</sup>

The broker-dealer must also check the reliability of the source of the information, particularly when the same source is providing updated information. If the broker-dealer seeks assurances or additional information from the source (in most cases, the issuer) about the matters cited in the Commission trading suspension order, great caution should be used before relying on the statements or assurances from the issuer. The broker-dealer may have to test the accuracy of the information or the source's reliability by conducting an independent review or

obtaining verification of information provided by the issuer. The broker-dealer may need to seek an opinion of an independent accountant or attorney to form a reasonable basis to believe that the Rule's information is accurate and from a reliable source. In one enforcement action, a broker-dealer unreasonably relied on pre-suspension financial statements when the Commission's trading suspension was based upon a lack of accurate financial information and the issuer's auditors indicated to the broker-dealer that they were having problems verifying the issuer's financial information.<sup>38</sup>

A broker-dealer may have difficulty obtaining the necessary information about an issuer after the expiration of a trading suspension. This difficulty, however, does not relieve the broker-dealer of its responsibilities under the Rule. If any broker-dealer is uncertain as to what is required by the Rule, it should refrain from entering quotations relating to the securities in question until the Rule's provisions have been met.

#### **IV. Examples of Red Flags**

If the broker-dealer discovers at any stage of the review process any red flags in the issuer information (whether the issuer is a reporting or non-reporting company), it cannot publish a quote unless and until those red flags are reasonably addressed. Material inconsistencies in the paragraph (a) [reproposed paragraph (c)] information, or material inconsistencies between that information and the paragraph (b) [reproposed paragraph (d)] information, are red flags. We have set out below examples of red flags that we have noticed in microcap fraud cases or in Rule 15c2-11 submissions made to the NASD. These examples, however, are not comprehensive, as red flags depend on the facts and circumstances of each case.

We are providing examples of red flags that require additional scrutiny by the broker-dealer to comply with Rule 15c2-11. These examples, however, are not exhaustive. Conversely, the presence of these or other red flags is not necessarily an indication of microcap fraud or even inaccurate issuer information. The red flag simply means that the broker-dealer should question whether the issuer information is accurate, and in certain cases, from a reliable source. The more red flags that are present, the more a broker-dealer should scrutinize the issuer information.

1. *Commission Trading Suspensions.* As indicated above, Commission trading suspension orders generally raise significant red flags as to whether the Rule 15c2-11 information is accurate and whether its source is reliable. Broker-dealers publishing quotes once a trading suspension terminates must satisfy the Rule's requirements, which

may include seeking verification from the issuer or soliciting the views of an independent professional.

2. *Foreign Trading Suspensions.* A trading suspension by a foreign regulator may indicate that the issuer information is unreliable or inaccurate. However, a trading suspension in a foreign market may be imposed simply because the issuer failed to meet exchange listing standards. If the broker-dealer learns of a foreign trading suspension, it should attempt to determine the basis for the suspension order and assess whether the issuer information is still accurate and whether its source is still reliable.

3. *Concentration of ownership of the majority of outstanding, freely tradeable stock.* Concentration of ownership of freely tradeable securities is a prominent feature of microcap fraud cases. When one person or group controls the flow of freely tradeable securities, this person or persons can have a much greater ability to manipulate the stock's price than when the securities are widely held. In a "pump and dump" scheme, retail interest is stimulated, and the price of the securities is manipulated upward, at the behest or under the control of the manipulators who control much of the stock. Often, other broker-dealers that are not intentionally participating in improper activities publish quotations in response to escalating demand for the security resulting from increasing retail sales. The promoters of these companies, company insiders, and unscrupulous brokers make substantial profits when they sell their shares at inflated prices. When the scheme is over, the security's price plummets, and innocent investors who paid a premium price are left holding worthless shares.<sup>39</sup>

4. *Large reverse stock splits.* Microcap fraud schemes can involve the substantial concentration of the publicly-traded float through a reverse stock split. The subsequent issuance of large amounts of stock to insiders increases their control over both the issuer and trading of the stock.<sup>40</sup>

5. *Companies in which assets are large and revenue is minimal without any explanation.* A red flag exists when the issuer assigns a high value on its financial statements to

<sup>35</sup> See Section 12(k) of the Exchange Act. Information regarding recent trading suspension orders can be obtained by calling 800-SEC-0330. The broker-dealer must obtain a copy of the trading suspension order or a copy of the Commission release announcing the trading suspension. Copies of Commission releases may be obtained through our Internet website at <<http://www.sec.gov/enforce/tsuspend.htm>> or from the Commission's Public Reference Room in Washington, D.C. and in regional Commission offices. Also, Commission releases are available from information databases (e.g., LEXIS), and also are published in the SEC Docket, which is available from publication services (e.g., Commerce Clearing House, Inc.).

<sup>36</sup> The reproposal contains a presumption that the financial information of both reporting issuers and domestic and foreign non-reporting issuers is current if it is less than 15 months old. However, if the broker-dealer has other information that indicates that the issuer's financial condition has materially changed from that shown in the financial statements, this presumption may not apply, and the broker-dealer should determine whether more recent financial information is available. Financial information older than 15 months is not current and does not satisfy the Rule's requirements.

<sup>37</sup> *General Bond & Share Co.*, 51 S.E.C. 411 (1993) (Commission opinion), *rev'd on other grounds*, *General Bond & Share Co. v. SEC*, 39 F.3d 1451 (10th Cir. 1994); *See also Robin Rushing and Harold Gallison, Jr.*, Securities Exchange Act Release No. 36910 (February 29, 1996).

<sup>38</sup> *Robin Rushing and Harold Gallison, Jr.*, Securities Exchange Act Release No. 36910 (February 29, 1996); *see also Bagle Securities, Inc.*, Securities Exchange Act Release No. 27673 (February 5, 1990); *William V. Frankel & Company*, Securities Exchange Act Release No. 27649 (January 26, 1990); *Richfield Securities, Inc.*, Securities Exchange Act Release No. 26129 (September 29, 1988).

<sup>39</sup> *See New Allied Development Corporation*, Securities Exchange Act Release No. 37990 (November 26, 1996) (New Allied's control persons had substantial stock interest in nominee accounts); *Douglass and Co., Inc.*, 46 S.E.C. 1189 (1978); *Gotham Securities Corporation*, 46 S.E.C. 723 (1976). Paragraph (c)(6)(x) of the repropoed Rule will require disclosure of the beneficial ownership of the issuer's stock by its executive officers, directors, general partners, promoters, or control persons.

<sup>40</sup> Emshwiller, "Reverse Stock Splits At Many Firms Spark Outcry," *The Wall Street Journal*, November 20, 1998, at C1; *SEC v. Magna Technologies, Inc.*, Litigation Release No. 12227 (August 21, 1989) (insiders of Magna effected a 4-for-1 reverse stock split, concentrated ownership in themselves, and then manipulated the price of Magna's stock by disseminating false and misleading information).

certain assets that are often unrelated to the company's business and were recently acquired in a non-cash transaction. In this situation, the company's revenues often are minimal and there appears to be no valid explanation for such large assets and minimal revenues.<sup>41</sup>

Also, a red flag is present when the financial statements of a development stage issuer list as the principal component of the issuer's net worth an asset wholly unrelated to the issuer's line of business. For example, from a review of Rule 15c2-11 submissions, art collections or other collectibles that are unrelated to the issuer's business apparently have been overvalued on the financial statements of some issuers.<sup>42</sup> While assets that are unrelated to the business of the issuer are not always an indication of potential microcap fraud, some unscrupulous issuers have overvalued these types of assets in an effort to inflate their balance sheets.

6. *Shell corporation's acquisition of private company.* A shell corporation is characterized by no business operations and little or no assets. In a fraud scheme, a reporting company with a large number of shares controlled by one person or a small number of persons often merges with a non-reporting company having some business operations. The new public company is then used as the vehicle for "pump and dump" and other fraudulent schemes. Broker-dealers placing quotes for these issuers' securities should be mindful of the potential for abuse.<sup>43</sup>

7. *Offerings under Rule 504 of Regulation D where one or more of the following factors are present:*

- Little capital is raised in the Rule 504 offering and there appears to be no business purpose except to provide some shareholders with free-trading shares;
- The Rule 504 offering is preceded by an unregistered offering to insiders or others for services rendered at prices well below the price in the subsequent offering;
- Sales immediately following the Rule 504 offering are at substantially higher prices than those paid in the Rule 504 offering; or
- A shell company and an operating company merge, which results in the operating entity becoming the surviving entity. The surviving entity goes "public" by issuing shares pursuant to Rule 504.<sup>44</sup>

<sup>41</sup> *New Allied Development Corporation*, Securities Exchange Act Release No. 37990 (November 26, 1996).

<sup>42</sup> *In the Matter of Rom N. De Guzman*, Securities Exchange Act Release No. 37747 (September 30, 1996).

<sup>43</sup> *New Allied Development Corporation*, Securities Exchange Act Release No. 37990 (November 26, 1996); *Styler Homes, Inc.*, Securities Exchange Act Release No. 36299 (September 29, 1995); *Bunker Securities, Inc.*, 48 S.E.C. 859 (1987), *aff'd without opinion*, 833 F. 2d 303 (3d Cir. 1987); *Butcher & Singer, Inc.*, 48 S.E.C. 640, *aff'd without opinion*, 833 F. 2d 303 (ed Cir. 1987); *Douglass and Co., Inc.*, 46 S.E.C. 1189 (1978); *A.J. Carmo Co.*, 1976 SEC LEXIS 2764 (February 23, 1976) (initial decision), *order dismissing proceeding and withdrawing broker-dealer registration*, Securities Exchange Act Release No. 14647 (April 10, 1978); *Gotham Securities Corporation*, 46 S.E.C. 723 (1976).

<sup>44</sup> See example 16, above.

Rule 504 of Regulation D allows non-reporting companies to raise up to \$1 million per year in "seed capital" without complying with Securities Act registration requirements. The freely tradable nature of securities issued in Rule 504 offerings has facilitated a number of fraudulent schemes through the OTC Bulletin Board Display Service (OTC Bulletin Board) or the Pink Sheets published by the National Quotation Bureau, Inc. (NQB).<sup>45</sup> Broker-dealers should be alert to information in the Rule 15c2-11 materials where an active trading market is being promoted for securities issued solely in a Rule 504 transaction.

8. *A registered or unregistered offering raises proceeds that are used to repay a bridge loan made or arranged by the underwriter where:*

- The bridge loan was made at a high interest rate for a short period;
- The underwriter received securities at below-market rates prior to the offering; and
- The issuer has no apparent business purpose for the bridge loan.

Broker-dealers have given small issuers bridge loans at a high interest rate for a short time period.<sup>46</sup> In exchange for this bridge loan, the broker-dealer receives a significant number of shares of the issuer's common stock at a price that is substantially below market rates. The broker-dealer then engages in a scheme to manipulate the stock's price and ultimately benefits when it dumps the stock at an artificially high price.<sup>47</sup>

9. *Significant write-up of assets upon a company obtaining a patent or trademark for a product.* The significant write-up of assets upon the issuer's obtaining a patent or trademark for a product is a technique used by issuers engaged in microcap fraud to inflate their balance sheets.<sup>48</sup>

10. *Significant asset consists of OTC Bulletin Board or Pink Sheet companies.* We have noticed that some microcap fraud schemes involve issuers whose major assets are substantial amounts of shares in other OTC Bulletin Board or Pink Sheet companies.

11. *Assets acquired for shares of stock when the stock has no market value.* In

<sup>45</sup> See Securities Act Release No. 33-7644 (February 19, 1999) in which we adopted amendments to Rule 504 of Regulation D that limit the circumstances where general solicitation is permitted and "freely tradeable" securities may be issued in reliance on Rule 504 to transactions (1) registered under state law requiring public filing and delivery of a disclosure document to investors before sale, or (2) exempted under state law permitting general solicitation and general advertising so long as sales are made only to "accredited investors."

<sup>46</sup> Emshwiller, "NASD Quietly Takes Aim at IPO Bridge-Loan Trend," *The Wall Street Journal*, January 20, 1998, at C1.

<sup>47</sup> See *Memory Metals, Inc.*, Securities Act Release No. 6820 (February 22, 1989).

<sup>48</sup> *New Allied Development corporation*, Securities Exchange Act Release No. 37990 (November 26, 1996); see also *Frederick R. Grant*, Securities Exchange Release No. 38239 (February 5, 1997); *Atlantis Group, Inc.*, securities Exchange Act Release No. 37932 (November 8, 1996); *Eli Buchalter*, Securities Exchange Act Release No. 37702 (September 19, 1996); *Milton Mermelstein*, Securities Exchange Act Release No. 37222 (May 16, 1996).

microcap fraud cases, the issuer's financial statements often indicate that the issuer acquired assets to which it assigned substantial value in exchange for its essentially worthless stock.<sup>49</sup>

12. *Significant write-up of assets in a business combination of entities under common control.*

Those persons engaged in microcap fraud often use a business combination such as a merger as an opportunity to falsify financial statements.<sup>50</sup> We have seen microcap fraud schemes in which unscrupulous issuers use purchase method accounting<sup>51</sup> to write up the historical value of an asset to an artificially high value in situations when the entities involved in the business combination are under common control or otherwise have a high degree of common ownership. For example, Generally Accepted Accounting Principles (GAAP) requires that the acquisition of one entity by another entity be accounted for at historical cost in a manner similar to that in "pooling of interests" accounting when these entities are under common control.<sup>52</sup>

13. *Unusual auditing issues.*

- Auditors refuse to certify financial statements or they issue a qualified opinion; or
- There has been a change of accountants.<sup>53</sup>

<sup>49</sup> See *New Allied Development Corporation*, Securities Exchange Act Release No. 37990 (November 26, 1996) (the respondents obtained new Allied, a public shell, which was a dormant uranium mining company with no assets, in a transaction which resulted in insiders controlling 52.4% of New Allied's stock; New Allied then acquired an interest in real estate associated with worthless gambling concerns in exchange for New Allied stock); *Douglass and Co., Inc.*, 46 S.E.C. 1189 (1978).

<sup>50</sup> See *New Allied Development corporation*, Securities Exchange Act Release No. 37990 (November 26, 1996) (the respondents disseminated materially false documents to market makers, including unaudited financial statements, that valued new Allied's medical and consumer products at \$2,150,000 although their historical costs were approximately \$17,000); *A.J. Carmo Co.*, 1976 SEC LEXIS 2764 (February 23, 1976) (Initial Decision), *order dismissing proceeding and withdrawing broker-dealer registration*, Securities Exchange Act Release No. 14647 (April 10, 1978) (Management Dynamics, Inc.'s (MD) founding officer and director wrote MD shareholders to recommend the acquisition of the assets of a real estate developer. Press releases and shareholder letters reinforced the misleading impression that the transaction was certain to generate substantial income for MD).

<sup>51</sup> When two companies merge, compliance with Generally Accepted Accounting Principles requires that the combination be accounted for as either the "pooling method" or "purchase method." With the pooling method, the historical costs of the two companies are added together. With purchase method accounting, the company being acquired writes up its assets to fair market value, which generally are greater than the historical costs.

<sup>52</sup> *Ronald Effren*, Securities Act Release No. 7256, Securities Exchange Act Release No. 36713 (January 16, 1996); see also *Martin Halpern*, Securities Exchange Act Release No. 34727 (September 27, 1994).

<sup>53</sup> See Securities Exchange Act Form 8-K, Item 4; *Merle S. Finkel*, Securities Act Release No. 7401 (March 12, 1997) (original auditors notified systems of Excellence that purported registration statement on Form S-8 had not been filed and that other

Rule 15c2-11 does not contemplate that the broker-dealer scrutinize the issuer's financial statements with the expertise of an accountant. The above red flags, however, do not require an expertise in accounting matters and have appeared in several microcap fraud schemes. In one case, the respondents stated in the Form 211 submissions to the NASD that they relied on audited financial statements. However, the auditors orally advised the associated persons of the broker-dealer before they submitted the Form 211 that the auditor's opinion attached to the *pro forma* financial statement was qualified because of the auditor's inability to verify the issuer's financial information.<sup>54</sup>

An accountant's resignation or dismissal is a characteristic found in some microcap fraud cases. If a broker-dealer sees any of these red flags, it should confirm the auditor's credentials with the appropriate state licensing authority, question the circumstances of the change in accountants, and carefully scrutinize the Rule's required information.

14. *Extraordinary items in notes to the financial statements, e.g., unusual related party transactions.* Unusual related party transactions are sometimes found in microcap fraud schemes. For example, an issuer's financial statements may show a related party transaction between two companies, which later merge and inflate the worth of their assets by using purchase method accounting.<sup>55</sup>

15. *Suspicious documents.*

- Inconsistent financial statements;
- Altered financial statements; or
- Altered certificates of incorporation.

Altered or facially inconsistent issuer documents have been present in various microcap fraud schemes. For example, Polaris Mining Co. was a shell corporation with no meaningful assets and no trading market for its stock.<sup>56</sup> Douglass and Co., Inc., a broker-dealer, published quotations for Polaris in the Pink Sheets in violation of Rule 15c2-11 because the Polaris financial information upon which Douglass and Co., Inc. relied was deficient and contradictory on its face: two balance sheets for the same years contained blatant disparities. Both balance sheets valued certain mined but unprocessed ores at the estimated eventual selling price even though significant processing work remained to be done. One statement did not list property location. One statement had an item for capitalized expenses and the other statement for the same year did not. The former statement showed no retained earnings or accumulated deficit, suggesting that the figure for capitalized expenses was

irregularities exist in connection with issuance of this stock; thereafter, Systems of Excellence retained new auditor who issued materially false or inaccurate audit reports.

<sup>54</sup> See *Robin Rushing and Harold Gallison, Jr.*, Securities Exchange Act Release No. 36910 (February 29, 1996). In this case, the SEC also had entered a trading suspension for lack of accurate financial information.

<sup>55</sup> See *Ronald Effren*, Securities Exchange Act Release No. 36713 (January 16, 1996).

<sup>56</sup> *Douglass and Co., Inc.*, 46 S.E.C. 1189 (1978).

an arbitrary one designed to make assets and liabilities balance out.<sup>57</sup>

In addition, issuer information that is altered on its face raises red flags that, at a minimum, require the broker-dealer to contact the issuer.<sup>58</sup>

16. *Broker-dealer receives substantially similar offering documents from different issuers with the following characteristics:*

- The same attorney is involved;
- The same officers and directors are listed; and/or
- The same shareholders are listed.

It is not uncommon for the same individuals to be involved in multiple microcap frauds. If a broker-dealer realizes after reviewing the information for several issuers that the same individuals are involved with these entities, the broker-dealer should make further inquiries to determine whether it has a reasonable basis to believe that the issuer information is accurate.

17. *Extraordinary gains in year-to-year operations.* In microcap fraud cases, the issuer may show extraordinary gains in its year-to-year operations. This may be accomplished through assigning an artificially high value to certain assets or through other manipulative devices that are red flags, such as the significant write-up of assets upon merger or acquisition.<sup>59</sup>

18. *Reporting company fails to file an annual report.* The fact that a reporting company has not filed an annual report suggests that there is a potential problem with the company.<sup>60</sup>

19. *Disciplinary actions against an issuer's officers, directors, general partners, promoters, or control persons.*

The following types of disciplinary actions should trigger further investigation by a broker-dealer:

- Indictment or conviction in a criminal proceeding;<sup>61</sup>
- Order permanently or temporarily enjoining, barring, suspending or otherwise limiting an officer, director, general partner,

<sup>57</sup> See also *Butcher & Singer, Inc.*, 48 S.E.C. 640, *aff'd without opinion*, 833 F.2d 303 (3d Cir. 1987) (a salesman and later an officer of Butcher & Singer apparently obtained some blank stock certificates and forged former officers' signatures as well as the certificates' amounts and purported dates of issuance to himself and his family members; the broker-dealer, Butcher & Singer, failed to review the Rule's required information; Butcher & Singer might have noticed red flags that would have led to the discovery of the underlying fraud if it had reviewed the Rule's required information).

<sup>58</sup> See *United States v. Marshall Zolp*, Litigation Release Nos. 11494 (July 23, 1987) and 11236 (October 2, 1986) (fictitious certificates of incorporation and fictitious financial statements on which the name of another company had been whitened out and the name of Laser Arms filled in).

<sup>59</sup> See, e.g., *A. J. Carno Co.*, 1976 SEC LEXIS 2764 (February 23, 1976) (Initial Decision), *order dismissing proceedings and withdrawing broker-dealer registration*, Securities Exchange Act Release No. 14647 (April 10, 1978).

<sup>60</sup> See *Combined Companies International Corp.*, Securities Exchange Act Release No. 38653 (May 19, 1997); *Robin Rushing and Harold Gallison, Jr.*, Securities Exchange Act Release No. 36910 (February 29, 1996).

<sup>61</sup> *Styler Homes, Inc.*, Securities Exchange Act Release No. 36299 (September 29, 1995).

promoter, or control person's involvement in any type of business, securities, commodities, or banking activities;

- Adjudication by civil court of competent jurisdiction, the Commission, the Commodity Futures Trading Commission or a state securities regulator to have violated federal or state securities or commodities law; or
- Order by a self-regulatory organization permanently or temporarily barring, suspending or otherwise limiting involvement in any type of business or securities activities.<sup>62</sup>

Many microcap fraud cases involve recidivist securities law violators.<sup>63</sup> If a broker-dealer has information or could reasonably discover information about the above types of violations, it should question whether it has a reasonable basis to believe that the issuer's information is accurate and complete in these circumstances.

20. *Significant events involving an issuer or its predecessor, or any of its majority owned subsidiaries.*

The following types of significant events should prompt further investigation by a broker-dealer:

- Change in control of the issuer;<sup>64</sup>
- Substantial increase in equity securities;
- Merger, acquisition, or business combination;
- Acquisition or disposition of significant assets;<sup>65</sup>

Bankruptcy proceedings;<sup>66</sup> or

Delisting from any securities exchange or the Nasdaq Stock Market.<sup>67</sup>

While not necessarily problematic, these are material events involving the issuer. The change in control of the issuer, merger, acquisition, or business combination, acquisition or disposition of significant assets can provide unscrupulous issuers an opportunity to artificially overvalue the issuer's assets to support an upward manipulation of the issuer's worthless

<sup>62</sup> The repropoed text of Rule 15c2-11(c)(6)(xi)(A)(2) requires the broker-dealer to review these factors for non-reporting issuers. Otherwise, under the repropoed text of Rule 15c2-11(c)(6)(xi)(B) or (C), the broker-dealer must obtain a statement from the issuer that none of these events has occurred or must record the steps taken to obtain this information and that the issuer refused or failed to provide it. Even though the current Rule does not require the broker-dealer to obtain and review this information, we consider such information to be red flags under the Rule if it comes to the broker-dealer's attention.

<sup>63</sup> See *SEC v. I-Net Providers*, Litigation Release No. 15219 (January 17, 1997); *New Allied Development Corporation*, Securities Exchange Act Release No. 37990 (November 26, 1996).

<sup>64</sup> See Exchange Act Form 8-K, Item 1.

<sup>65</sup> See Exchange Act Form 8-K, Item 2.

<sup>66</sup> See Exchange Act Form 8-K, Item 3.

<sup>67</sup> The proposed text of Rule 15c2-11(c)(6)(xii)(A) requires the broker-dealer to review these factors. Otherwise, under the proposed text of Rule 15c2-11(c)(6)(xii)(B) or (C), the broker-dealer must obtain a statement from the issuer that none of these events has occurred or must record the steps taken to obtain this information and that the issuer refused or failed to provide it. Even though the current Rule does not require the broker-dealer to obtain and review this information, we consider such information to be red flags under the Rule if it comes to the broker-dealer's attention.



stock.<sup>68</sup> An increase in the issuer's equity securities provides the securities necessary for such manipulation. Bankruptcy proceedings or a delisting from an exchange or the Nasdaq Stock Market may also indicate problems with an issuer that could lead the broker-dealer to conclude that it does not have a reasonable basis to believe that the issuer's financial information is accurate.<sup>69</sup>

21. *Request to publish both bid and ask quotes on behalf of a customer for the same stock.* The highly unusual request from a customer for the broker-dealer to publish both bid and ask quotes is a red flag "that calls for appropriate inquiry on [the broker-dealer's] part."<sup>70</sup>

22. *Issuer or promoter offers to pay a "due diligence" fee.* If a market maker receives an offer from an issuer to pay a "due diligence" fee in connection with making a market in the issuer's security, this is not solely a red flag.<sup>71</sup> It is a violation of NASD Rule 2460 for the broker-dealer to accept this offer.<sup>72</sup> If the broker-dealer receives any consideration in connection with publishing a quotation, the repropose Rule requires the broker-dealer to disclose any such compensation, as well as any other significant relationship information between the issuer and the broker-dealer publishing the quotation or any of its associated persons.<sup>73</sup> In *Douglass and Co., Inc.*, a registered representative said he would try to get the broker-dealer to initiate a market in the stock of Polaris Mining Co., but that it would cost the issuer about \$1,500 to cover "expenses." The registered representative later agreed to accept Polaris stock (some of which he kept himself) instead of the \$1,500.<sup>74</sup>

<sup>68</sup> See *New Allied Development Corporation*, Securities Exchange Act Release No. 37990 (November 26, 1996); *A. J. Carno Co.*, 1976 SEC LEXIS 2764 (February 23, 1976)(Initial Decision), order dismissing proceedings and withdrawing broker-dealer registration, Securities Exchange Act Release No. 14647 (April 10, 1978); see also *Bion Environmental Technologies, Inc.*, Securities Exchange Act Release No. 36111 (August 16, 1995).

<sup>69</sup> See *B.J. Thomas*, Securities Exchange Act Release No. 38727 (June 10, 1997); *SEC v. Magna Technologies, Inc.*, Litigation Release No. 12227 (August 21, 1989); see e.g., *Milton Mermelstein*, Securities Exchange Act Release No. 37222 (May 16, 1996).

<sup>70</sup> *Alessandrini & Co., Inc.*, 45 S.E.C. 399 (1971), citing *D.H. Blair & Co.*, 44 S.E.C. 320 (1970).

<sup>71</sup> *Butcher & Singer, Inc.*, 48 SEC 640, *aff'd without opinion*, 833 F.2d 303 (3d Cir. 1987)(a salesman received 400,000 shares of an obscure penny stock for helping to develop and maintain a market in the stock); see *Brent Duane Green*, Securities Exchange Act Release No. 39210 (October 7, 1997); *Steven Ira Wertman*, Securities Exchange Act Release No. 38751 (June 20, 1997); *Christopher D. Jennings*, Securities Exchange Act Release No. 38696 (May 30, 1997).

<sup>72</sup> NASD Rule 2460, Payments for Market Making, prohibits any payment by an issuer or the issuer's affiliates and promoters, directly or indirectly, to a member for publishing a quotation, acting as a market maker, or submitting an application.

<sup>73</sup> See repropose Rule 15c2-11(e); see also current Rule 15c2-11(a)(5)(xvi).

<sup>74</sup> *Douglass and Co., Inc.*, 46 S.E.C. 1189 (1978); see also *See Robin Rushing and Harold Gallison, Jr.*, Securities Exchange Act Release No. 36910 (February 29, 1996); *General Bond & Share Co.*, 51 S.E.C. 411 (1993)(Commission opinion), *rev'd on other grounds*, *General Bond & Share Co. v. SEC*, 39 F.3d 1451 (10th Cir. 1994).

23. *Regulation S transactions of domestic issuers.* Regulation S<sup>75</sup> provides a safe harbor from the registration requirements of the Securities Act of 1933 for offers and sales of securities by both foreign and domestic issuers that are made outside the United States. We recently adopted amendments to Regulation S that are designed to prevent the abuses that relate to offshore offerings of equity securities of domestic issuers.<sup>76</sup> Prior to the recent amendments, Regulation S transactions involving large amounts of the securities of U.S. issuers were particularly vulnerable to fraud and manipulation.<sup>77</sup> The perpetrators of the fraud sold the securities to U.S. investors after the 40-day holding period expired, and little information was available to investors about the issuers.

Under the amendments, equity securities of U.S. issuers that are sold offshore under Regulation S are classified as "restricted securities" within the meaning of Rule 144 under the Securities Act, and the period during which these securities cannot be distributed in the United States is lengthened from 40 days to one year. These amendments make Regulation S abuses less likely, but broker-dealers should be alert to any questionable activities once the one-year holding period expires.

24. *Form S-8 stock.* Form S-8 is the short-form registration statement for offers and sales of a company's securities to its employees, including consultants and advisors.<sup>78</sup> The form has been abused by unscrupulous issuers to register on Form S-8 securities nominally offered and sold to employees or, more commonly, to so-called consultants and advisors. These persons then resell the securities in the public markets, at the direction of the issuer or a promoter.<sup>79</sup> In a typical pattern, an issuer registers on Form S-8 securities underlying options issued to so-called consultants where, by prearrangement, the issuer directs the consultants' exercise of the options and resale of the underlying securities in the public market. The consultants then either remit to the issuer the proceeds from the sale of the underlying shares, or apply the proceeds to pay debts of the issuer that are not related to any services provided by the consultants.<sup>80</sup> In some cases, these consultants perform little or no other service for the issuer. In other microcap frauds, the issuer uses Form S-8 to sell securities to

"employees" who act as conduits by selling the securities to the public and remitting the proceeds (or their economic benefit) to the issuer.<sup>81</sup> This public sale of securities by the issuer has not been registered, although the Securities Act requires registration. The failure to register this sale of securities deprives public investors of the protections afforded by the Securities Act.

To prevent these abuses, Form S-8 and related rules impose certain restrictions on the use of the form for the sale of securities to certain consultants and advisors.<sup>82</sup> We are also proposing additional amendments to Form S-8.<sup>83</sup> Although these amendments should deter microcap abuses, broker-dealers nevertheless should be aware of the prior abuses of Form S-8 in microcap fraud cases.

25. *"Hot industry" microcap stocks.* Another characteristic of microcap fraud cases is that they often involve stocks that are in vogue.<sup>84</sup> In the past, oil and gas ventures and mining operations, as well as stocks of issuers with purportedly innovative products, have been popular in frauds involving low-priced stocks.

26. *Unusual activity in brokerage accounts of issuer affiliates, especially involving "related" shareholders.* Many microcap frauds begin with the deposit and sale of large blocks of an obscure stock by a new and unfamiliar customer who often is affiliated with an issuer.<sup>85</sup> At the same time, the broker-dealer is encouraged to make a market in the stock by the issuer.

27. *Companies that frequently change names.* Frequent name changes are another characteristic that we have seen in microcap fraud cases. For example, Twenty First Century Health (TFCH) was originally a company called Big Valley Energy, Inc. Big Valley then changed its name to Biotronic Energy Engineering, Inc., then to The Sonoron Group, then to Zorro International, Inc., then to Health & Wealth, Inc., and finally became TFCH in 1995. At the promoter's request, TFCH issued false audited financial statements that recorded material, nonexistent assets.<sup>86</sup>

28. *Companies that frequently change their line of business.* Besides companies that frequently change their names, we also see

<sup>81</sup> See *S.E.C. v. Charles O. Huttoe*, Litigation Release Nos. 15153 (November 7, 1996); 15185 (December 12, 1996)(unregistered public offering purporting to use Form S-8).

<sup>82</sup> Securities Act Release No. 33-7646 (February 19, 1999).

<sup>83</sup> Securities Act Release No. 33-7647 (February 19, 1999).

<sup>84</sup> See *Douglass and Co., Inc.*, 46 S.E.C. 1189 (1978) (November 26, 1996)(mining operation); see also *S.E.C. v. Bradley J. Simmons and American Energy Group, Ltd*, Litigation Release No. 15353 (April 29, 1997)(oil and gas company).

<sup>85</sup> *Laser Arms Report*, 50 S.E.C. 489, 503; see also *Butcher & Singer, Inc.*, 48 S.E.C. 640, *aff'd without opinion*, 833 F.2d 303 (3d Cir. 1987); *Gotham Securities Corporation*, 46 S.E.C. 723 (1976) (the family of the broker-dealer's principal owned a significant amount of the stock of Marcon Electronics Corp., which was a shell corporation with no assets; the family benefited when the broker-dealer manipulated upward the price of the Marcon stock).

<sup>86</sup> *Merle S. Finkel*, Securities Act Release No. 7401 (March 12, 1997).

<sup>75</sup> 17 CFR 230.901-230.905 and Preliminary Notes.

<sup>76</sup> Securities Act Release No. 7505 (February 17, 1998), 63 FR 9632. We also adopted amendments that would affect applicable reporting requirements along with other amendments intended to prevent abuses of Regulation S. Since January 1, 1999, Regulation S transactions are required to be reported quarterly on Forms 10-Q and 10-K.

<sup>77</sup> See *Frederick R. Grant*, Securities Exchange Release No. 38239 (February 5, 1997); *S.E.C. v. Enviromint Holdings, Inc.*, Litigation Release No. 14683 (October 6, 1995).

<sup>78</sup> Form S-8 under the Securities Act of 1933 (15 U.S.C. 77a et seq.).

<sup>79</sup> See *S.E.C. v. Enviromint Holdings, Inc.*, Litigation Release No. 14683 (October 6, 1995).

<sup>80</sup> See, e.g., *Spectrum Information Technologies, Inc.*, Securities Act Release No. 7426 (June 25, 1997); *SEC v. Hollywood Trenz, Inc.*, Litigation Release No. 15730.



companies that frequently change their line of business in microcap fraud cases. For example, New Allied Development started out as a uranium mining company that was

a dormant public shell with no assets.<sup>87</sup> New Allied then acquired the rights to medical products in exchange for its overvalued

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<sup>87</sup> *New Allied Development Corporation*, Securities Exchange Act Release No. 37990 (November 26, 1996).

stock. Next, New Allied became a vehicle to enter the gaming business purportedly to build a casino.

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