

September 1998

# SEC ENFORCEMENT

## Responses to GAO and SEC Recommendations Related to Microcap Stock Fraud



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General Government Division

B-279399

September 30, 1998

The Honorable Susan M. Collins  
Chairman  
The Honorable John Glenn  
Ranking Minority Member  
Permanent Subcommittee on Investigations  
Committee on Governmental Affairs  
United States Senate

The Honorable John D. Dingell  
Ranking Minority Member  
Committee on Commerce  
House of Representatives

In separate letters, dated December 12, 1997, and February 23, 1998, respectively, you expressed concern over reported increases in fraud involving microcap stock—the stock of companies with low-priced securities and minimal capital. You also indicated interest in the actions securities regulators have taken to combat such fraud. As an initial step, you requested that we inform you of the actions taken in response to recommendations in our and Securities and Exchange Commission (SEC) reports that address issues related to microcap stock fraud. This report summarizes the May 27, and 28, 1998, briefings we provided your respective offices on the status of SEC and self-regulatory organization (SRO)<sup>1</sup> actions on these report recommendations.

## Results in Brief

SEC and the SROs have taken, or reported taking, actions that respond to many of the recommendations in our and SEC reports that address issues related to microcap stock fraud. In responding to these recommendations, actions have been taken to (1) expand the disclosure of and public access to broker disciplinary information, (2) improve National Association of Securities Dealers (NASD)<sup>2</sup> branch office examination selection, (3) provide more focused sales practices examinations, (4) improve compliance with industry reporting requirements, and (5) implement a continuing professional education requirement for broker-dealers.<sup>3</sup> These actions

<sup>1</sup>SROs are private membership organizations given authority and responsibility under federal law and regulations to adopt and enforce rules of member conduct. Securities SROs include the stock exchanges, National Association of Securities Dealers, and Municipal Securities Rulemaking Board.

<sup>2</sup>NASD operates the Nasdaq Stock Market, Inc., and, through its independent subsidiary NASD Regulation, Inc., establishes and enforces standards of industry conduct.

<sup>3</sup>A broker-dealer is a registered firm that buys and sells securities for its customers and itself.

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should enhance regulatory oversight of microcap stock firms and help provide investors with additional protections against abusive practices by such firms.

Actions have not been completed that would respond to other recommendations related to the (1) migration of unscrupulous brokers from the securities industry to other financial services industries; (2) modernization of the central registration database (CRD) to improve oversight of problem brokers and public access to broker disciplinary histories; (3) ability of SEC to identify, across firms, trends in violations found during its broker-dealer examinations; and (4) provision of information on the availability of broker disciplinary histories before activity occurs in an account. Completing actions on these recommendations would further enhance regulatory oversight and investor protection.

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## Background

The term microcap security is not defined in the federal securities laws. Microcap securities include penny stocks<sup>4</sup> and generally describe the low-priced securities of companies with market capitalizations of less than \$300 million. Prices of microcap securities may be quoted on the NASD over-the-counter (OTC) Bulletin Board,<sup>5</sup> in the National Quotation Bureau's Pink Sheets,<sup>6</sup> or on the Nasdaq Small Cap Market.<sup>7</sup>

Public information on microcap securities is limited; often a small number of broker-dealers dominate trading, making the securities more susceptible to fraud. Microcap fraud is typically associated with "pump and dump" schemes involving high pressure sales tactics designed to induce investors to purchase relatively worthless stocks in which the firm or other insiders hold a large inventory. When successful, these high pressure sales tactics result in an increase in the price of the targeted stock (pump). Insiders then sell (dump) their shares, sometimes realizing large profits at the expense of public investors. A variety of other fraudulent practices are also used as part of these schemes, including "bait

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<sup>4</sup>Penny stocks are generally defined by SEC rules as stocks having an offer price of less than \$5.

<sup>5</sup>NASD's OTC Bulletin Board is a quotation service that displays real-time quotes, last-sale prices, and volume information on OTC securities. OTC securities are not listed or traded on a national securities exchange.

<sup>6</sup>The National Quotation Bureau's Pink Sheets are daily printed listings containing quotations for thousands of OTC stocks that are not listed on a major stock market.

<sup>7</sup>The Nasdaq Small Cap Market includes the securities of more than 1,300 smaller, less-capitalized companies that do not qualify for inclusion in the Nasdaq National Market.

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and switch” tactics, unauthorized trading, failure to execute sell orders, and excessive markups or price increases. Firms investigated for microcap fraud have typically been owned or controlled by individuals with ties to other firms with a history of stock fraud.

The securities markets, of which microcap securities are a part, are regulated by SEC, industry SROs, and state securities regulators. The SROs monitor members, including individuals and firms, for compliance with federal and SRO requirements. Among its responsibilities, SEC inspects SRO compliance programs for adequacy and conducts examinations of broker-dealers, including microcap firms. The states license firms and individuals to operate in their jurisdictions. Many states also conduct on-site examinations of broker-dealers.

To centralize broker licensing and registration, NASD and the North American Securities Administrators Association (NASAA)<sup>8</sup> established CRD in 1981. The database was designed to provide a more efficient licensing and registration process by eliminating redundant state reporting requirements. Operated by NASD Regulation Inc. (NASDR), CRD’s centralized computer system has allowed individual brokers and firms to satisfy both state and NASD reporting requirements. Over the years, however, CRD’s role has expanded to serve several other regulatory functions, such as gathering information for federal, state, and SRO enforcement and examination purposes, including identifying problem brokers or firms. CRD has also become the primary source of information for NASD’s public disclosure program. Among other things, this program provides investors with information on the professional background, business practices, and conduct of NASD member firms and their brokers. The information is available via NASDR’s toll-free telephone information service (hotline) or its Internet web site.

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## Scope and Methodology

To determine the status of SEC and SRO actions on recommendations in our and SEC reports that address issues related to microcap stock fraud, we reviewed SEC, NASD, and New York Stock Exchange (NYSE) documents that report on their respective actions. We also interviewed officials of the SEC Divisions of Enforcement and Market Regulation, SEC Office of Compliance Inspections and Examinations, the Department of Justice,

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<sup>8</sup>NASAA is a voluntary association of state, provincial, and territorial securities administrators in the United States, Canada, and Mexico that is devoted to investor protection and efficient capital formation.

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NASDR, NYSE, NASAA, and Securities Industry Association.<sup>9</sup> In addition, we analyzed SEC and SRO data on examinations completed, customer complaints, and disciplinary actions taken from 1992 through 1997.

We did our fieldwork between February and July 1998 in accordance with generally accepted government auditing standards. We obtained written comments on a draft of this report from SEC. These comments are discussed at the end of this letter and are reprinted in appendix II.

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## The Actions Taken Respond to Many of Our Recommendations

SEC and the SROs have taken actions that respond to many of the recommendations in our reports that address issues related to microcap stock fraud.<sup>10</sup> The reports with recommendations that were acted on focused on penny stock fraud;<sup>11</sup> unscrupulous brokers (brokers who have committed a significant breach of sales practice rules or have a history of repeated sales practice violations);<sup>12</sup> and NASD's toll-free telephone hotline.<sup>13</sup>

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## Penny Stock Report

Our 1993 report on penny stock fraud recommended that SEC require NASD to (1) provide callers using its toll-free telephone hotline with information on final arbitration awards and (2) identify and examine high-risk branch offices of penny stock broker-dealers. NASD's public disclosure program, which includes its toll-free telephone hotline, now provides information on, among other things, all consumer-initiated arbitrations that are pending or have been settled (for \$10,000 or more) and final arbitration decisions that resulted in an award to the customer. NASD district offices also target branch offices for review based on complaints of customers, termination of registered representatives for cause, and transactions in

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<sup>9</sup>The Securities Industry Association is a trade group that represents broker-dealers.

<sup>10</sup>Some of the actions taken on our recommendations involved changes to industry rules. See appendix I for a list of new, amended, and proposed SEC and SRO rules addressing our and SEC report recommendations and/or microcap stock fraud.

<sup>11</sup>See *Penny Stocks: Regulatory Actions to Reduce Potential for Fraud and Abuse* (GGD-93-59, Feb. 3, 1993), which addresses NASD's efforts to reduce fraud and abuse in the penny stock market.

<sup>12</sup>See *Securities Markets: Actions Needed to Better Protect Investors Against Unscrupulous Brokers* (GGD-94-208, Sept. 14, 1994), which addresses the extent to which unscrupulous brokers were active in the securities industry, regulatory and industry efforts to discipline unscrupulous brokers, and the industry's ability to identify unscrupulous brokers through CRD.

<sup>13</sup>See *NASD Telephone Hotline: Enhancements Could Help Investors Be Better Informed About Brokers' Disciplinary Records* (GGD-96-171, Aug. 19, 1996), which addresses the accessibility of the NASD hotline to investors, including how investors were informed about the hotline; what perceptions users had about the usefulness and appropriateness of the types of information provided by the hotline; and whether the information provided by the hotline met NASD disclosure policies.

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microcap stocks. In addition, NASD is developing an automated risk-based approach to examination scheduling to identify broker-dealers and branch offices for examination.

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### Unscrupulous Broker Report

Our 1994 report on unscrupulous brokers recommended that SEC impose a permanent industry bar, with no opportunity for reentry, on certain problem brokers and ensure that CRD includes SRO formal disciplinary actions as well as information on customer complaints and their dispositions. SEC clarified in September 1994 that, absent extraordinary circumstances, persons subject to bars with no provision for readmission to the securities industry would be unable to establish that the public interest was served by allowing their reentry. Also, SEC officials said that they have begun an inspection of NASDR that will review actions taken on reentry applications. In addition, the NASD public disclosure program now discloses SRO formal regulatory actions as well as customer complaints and their disposition.

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### NASD Hotline Report

Our 1996 report on the NASD hotline recommended that SEC encourage NASDR to (1) publicize its hotline number to more investors, such as by including the number on account-opening documents; (2) provide hotline callers with all relevant CRD disciplinary-related information or, at a minimum, inform them that the information is available from most state regulators; (3) make disciplinary-related information directly available to investors through the Internet; and (4) ensure that the CRD information provided to callers is disclosable and complete.

Addressing these recommendations, SEC approved an NASD rule on September 10, 1997, that requires members to provide customers, at least annually, with written information on the NASDR hotline telephone number, its Internet address, and the availability of a brochure describing NASD's public disclosure program. In addition to informing investors of the availability of information from state regulators, as of March 16, 1998, NASD reports information related to pending and final disciplinary actions, civil judgments, arbitration decisions, pending customer complaints, criminal convictions, settlements of \$10,000 or more, and bankruptcies. On the same date, CRD information also became available to the public over the Internet, with disciplinary information available via electronic mail (discussed below). To better ensure the quality of the CRD data disclosed, NASD now requires an additional review prior to data input, has instituted a statistical quality-control process to measure the accuracy of disclosures,

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and has added a requirement for periodic examination of data by data quality professionals.

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## The Actions Reported Respond to Many SEC Recommendations

SEC and the SROs have reported taking actions that respond to many recommendations in two SEC reports that address issues related to microcap stock fraud.<sup>14</sup> The first report addressed the sales practice oversight of nine large broker-dealers (the large firm project report).<sup>15</sup> The second report followed up on the first and focused on firms with problem brokers (the sales practice sweep report).<sup>16</sup>

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### Large Firm Project Report

The 1994 large firm project recommended that SEC and the SROs devote additional resources to sales practice examinations and to identifying and prosecuting problem brokers. The large firm report also recommended that (1) the SROs disclose all pending disciplinary actions, (2) NASD require its members to report customer complaints quarterly, (3) SROs enhance their tracking of regulatory filings related to disciplinary actions and terminations and sanction firms for failing to promptly and accurately file required forms, (4) SEC take action to implement uniform policies governing liability for information provided in regulatory filings, and (5) the securities industry adopt a mandatory continuing education requirement.

In response to the large firm report recommendations, federal, state, and self regulators undertook the sales practice sweep.<sup>17</sup> As part of the sweep, 101 small- to medium-size broker-dealers were examined, focusing on the sales practices of selected problem brokers and the hiring and supervisory

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<sup>14</sup>Some of the actions taken on SEC recommendations involved changes to industry rules. See appendix I for a list of new, amended, and proposed SEC and SRO rules addressing our and SEC report recommendations and/or microcap stock fraud.

<sup>15</sup>See *The Large Firm Project: A Review of Hiring, Retention and Supervision Practices* (May 1994), which responded to concerns about the increased frequency and severity of sales practice abuses. SEC, NYSE, and NASD staff conducted 170 examinations of 9 firms and their 161 branch offices in 32 states in completing the project.

<sup>16</sup>See *Joint Regulatory Sales Practice Sweep: A Review of the Sales Practice Activities of Selected Registered Representatives and the Hiring, Retention, and Supervisory Practices of the Brokerage Firms Employing Them* (Mar. 1996), in which examiners interviewed 230 problem brokers during 179 branch examinations at 101 small-to-medium size firms.

<sup>17</sup>The sweep was conducted by SEC, NASD, NYSE, and the following state securities regulators: Alaska, Arizona, California, Colorado, Connecticut, District of Columbia, Florida, Idaho, Illinois, Iowa, Kansas, Maine, Maryland, Michigan, Montana, New Jersey, New Mexico, Nevada, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Puerto Rico, Texas, Utah, Virginia, Washington, and Wisconsin.



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practices of the firms employing them (discussed further below). As a result of the sweep, 28 firms and 23 brokers were referred for enforcement action. In response to both the large firm project and sweep report recommendations, SEC and the SROs reported increasing their examination focus on sales practices and hiring and supervisory practices. In addition, SEC drafted several new examination modules to further address microcap and penny stock fraud, sales practices, and hiring and supervising problem brokers. SEC consolidated its SRO inspection and broker-dealer examination programs and created a separate office of broker-dealer examination oversight to expand and give greater focus to the broker-dealer examination program. As discussed above, NASD is developing an automated risk-based examination system. Furthermore, NYSE added questions and procedures to its examinations and implemented a surveillance system to track brokers with disciplinary histories.

Also in response to the large firm report recommendations, SROs are now required to report all formal investigations as well as pending and final disciplinary actions to CRD for public disclosure. In addition, NASD members are required to report certain customer complaints within 10 business days and summary data on written customer complaints each quarter. In August 1994, SEC requested that the SROs closely monitor the timeliness of required filings and increase sanctions when noncompliance is discovered. In April 1998, NASD proposed a rule that would provide members with qualified immunity for statements made in good faith in filings related to disciplinary actions and terminations. In 1995, SEC approved a uniform industry continuing education program that requires periodic training in regulatory matters and ongoing programs by firms to keep brokers up to date. A permanent continuing education council was created to recommend the specific content of the curriculum and to monitor the program.

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## Sales Practice Sweep Report

The 1996 SEC sales practice sweep report recommended various voluntary best practices for hiring and supervising problem brokers and follow-up examinations for problem firms. As previously discussed, SEC and the SROs have reported increasing their examination focus on firms with problem brokers, improving the selection of firms for examination, and drafting new examination modules. The new modules should provide SEC a means of gauging adherence to the best practices. Also, in April 1997, NASD and NYSE issued a joint notice to members that encouraged the adoption of the best practices. Although adoption of these practices was voluntary, the

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notice provided guidance on heightened hiring and supervisory procedures for brokers with prior disciplinary histories, customer complaints, or arbitrations and detailed overall member supervisory responsibility under existing rules. The Securities Industry Association adopted a similar set of best practices.

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## Actions Have Not Been Completed on Some Recommendations

Although the actions taken have responded to many of our and SEC report recommendations, for some other recommendations, actions have not been completed. Actions have not been completed on our recommendations related to the migration of unscrupulous brokers from the securities industry; modernization of CRD to allow regulators to more easily monitor brokers with disciplinary histories; and ability of SEC to identify, across firms, trends in violations found during its broker-dealer examinations.<sup>18</sup> Also, SEC's recommendation that would require disclosures to customers on the availability of broker disciplinary information prior to account activity has not been implemented.

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## Action on the Migration of Unscrupulous Brokers Is Not Complete

Our report on unscrupulous brokers discussed the potential for brokers barred from the securities industry to migrate to other financial services industries, such as banking and insurance. As a result, we recommended that the Secretary of the Treasury work with SEC and other financial regulators to (1) increase disclosure of CRD information so that regulators can consider a broker's disciplinary history in allocating examination resources and employers can use the information in making hiring decisions and (2) determine whether legislation or additional reciprocal agreements between SEC and other financial regulators are necessary to prevent the migration of unscrupulous brokers to other financial services industries.

In 1996, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation proposed a rule that would have required banks to report the hiring of brokers to CRD and for brokers hired by banks to take NASD qualification examinations.<sup>19</sup> Among other things, the filings required by the proposed rule would have allowed bank regulators to consider a broker's disciplinary history in allocating examination resources, thereby,

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<sup>18</sup>See Securities Industry: Strengthening Sales Practice Oversight (GGD-91-52, Apr. 25, 1991), which addresses SEC oversight of SRO monitoring and enforcement of sales practice compliance among broker-dealers.

<sup>19</sup>61 Fed. Reg. 68,824 (1996).

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helping address the migration of unscrupulous brokers to the banking industry.<sup>20</sup> To date, the proposed rule has not been finalized. In June 1998, NASD expressed concern to the banking regulators over bank employees taking the NASD examination. NASD communicated that the use of its examinations would not test for knowledge of bank rules and regulations. NASD recommended that new bank-specific examinations be developed and offered to assist in developing them. No further agreements on this point have been reached.

In the absence of a rule change, no reporting has occurred and thus no record exists of the movement of unscrupulous securities brokers to banks or unregistered affiliates of banks. Completion of CRD's modernization (discussed further below) will not ensure effective surveillance of the migration of these brokers to banks because banks are not required to report to CRD.

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## The CRD Modernization Nears Completion

Recommendations in our unscrupulous broker and hotline reports addressed the need to modernize CRD to allow regulators to more easily monitor brokers with disciplinary histories and to improve public access to broker disciplinary information, including Internet access. Although many actions have been taken on these recommendations, including limited Internet access, the CRD modernization is not yet complete.

As previously discussed, CRD's original role as the securities industry's centralized licensing and registration system has expanded and now includes numerous other regulatory and disclosure functions. CRD's original technology, however, was not able to accommodate this expansion. As a result, NASD began a redesign of CRD in 1992. This redesign has taken longer than expected, partly because of a switch in 1997 to technology that would allow Internet access. When completed, regulatory components of the new system will provide (1) automatic reports to regulators when certain predefined events occur, such as multiple customer complaints against a broker; (2) greater detection of late, deficient, or missed report filings; and (3) customized analytical capabilities to help regulators identify industry compliance trends, including those associated with specific problem brokers and firms. Also when completed, investors will be able to view broker and firm disciplinary information while on line. Currently, this information can be requested on line, but the response is provided via electronic mail. Full

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<sup>20</sup>The agreement did not address the migration of unscrupulous brokers to the insurance industry.

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implementation of all system improvements, including enhanced regulatory functions and full Internet access, is scheduled for late 1999.

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### SEC Plans a New Examination Tracking System

Our 1991 report on SEC oversight of industry sales practices recommended that the agency explore ways to record and maintain information on the number of each type of violation found during on-site examinations of broker-dealers and, as one option, include this information in its examination tracking system, called the Examination Activity Tracking System (EATS). The intent of our recommendation was to address SEC's inability to identify, across firms, trends in violations found during examinations that could warrant greater regulatory attention. Having such a capability would enhance the agency's ability to more efficiently and effectively target its resources. According to SEC, its planned replacement of EATS with the Super Tracking and Reporting System (STARS) will allow headquarters and regional office staff to identify and analyze trends in violations. For example, SEC staff said they will be able to query the system to determine the number of firms within a state or across the United States that have been cited for specific violations, such as those related to books and records violations or specific types of fraudulent conduct. Also, according to SEC, in order to gather more information about the significance and extent of violations found in examinations, the full text of all reports will be stored on a computerized system, called Zyindex, that will enable staff to search all reports using key words and to compile an analysis of the information. SEC staff told us that implementation of STARS and Zyindex is scheduled to begin in the fall of 1998. If implemented as described, taken together, these enhanced capabilities would be consistent with our recommendation that SEC be able to analyze, across firms, trends in violations found during its examinations of broker-dealers.

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### Disclosures Are Not Required Before Activity Occurs in an Account

SEC's 1994 large firm report recommended that information on the availability of a broker's disciplinary history via NASD's toll-free hotline be disclosed to investors before any activity occurs in their accounts. Our hotline report suggested this information could be included on account-opening documents or account statements. Investors could use such information to protect themselves against unscrupulous brokers.

In 1992, SEC's penny stock rules had been amended to require that information on the availability of a broker's disciplinary history via NASD's toll-free hotline be provided to a customer before effecting any penny stock transaction with the customer. However, this rule did not cover

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nonpenny stock transactions (i.e., securities priced at \$5 or more). On September 10, 1997, SEC approved NASD Rule 2280, which required NASD members to provide information on the availability of broker disciplinary information to customers in writing at least annually, along with the Internet web site address of the NASD public disclosure program and a statement regarding the availability of an investor brochure describing the program. However, the NASD rule does not require that the information be provided before activity occurs in an account or at account opening.

Since the issuance of the SEC report, numerous additional efforts have been made to educate the public on the availability of information on a broker's disciplinary history through NASD's toll-free hotline and web site as well as through other information on how to invest safely. These efforts have included information made available through federal, state, and SRO Internet web sites, free publications on investing, and SEC town meetings for investors. NASD also stated that it includes the toll-free hotline number and web-site address on every disciplinary action press release and has publicized them in a multilingual radio and television public service announcement campaign, in investor fairs and seminars, and in conjunction with investor and other associations. As a result, access to this information is now more readily available and widely disseminated. Nonetheless, we believe SEC's initial rationale for recommending that information on a broker's disciplinary history be available to investors before any activity occurs in their accounts remains valid.

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## Conclusions

SEC and the SROS have taken actions that respond to many of our and SEC report recommendations. These actions have improved the availability of registration and disciplinary information on brokers and firms, branch office audit selection, and availability and analysis of customer complaints, which should enhance regulatory oversight and investor protection. We continue to support the need to implement prior recommendations related to the migration of unscrupulous brokers, completion of CRD modernization, ability of SEC to identify trends in violations across firms, and disclosure of the availability of broker disciplinary information before account activity. Full implementation of these recommendations should further enhance regulatory oversight and investor protection.

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## Agency Comments and Our Evaluation

Written comments from SEC on a draft of this report are contained in appendix II. SEC and NASD also provided technical comments on the draft report, which were incorporated as appropriate.

SEC said that most of SEC and our recommendations have been implemented and focused its comments on the four recommendations where actions have not been completed. SEC commented that it expects to continue working with NASD to complete the CRD upgrade. It also commented that planned enhancements to its examination tracking capabilities will enable it to identify trends in violations. If implemented as described, these enhanced capabilities would be consistent with the intent of our recommendation that SEC be able to analyze, across firms, trends in violations found during its broker-dealer examinations that could warrant greater regulatory attention. In addition, SEC explained NASD's concerns about the banking regulators' proposed rule on the migration of unscrupulous brokers.

Finally, regarding SEC's recommendation to disclose the availability of broker disciplinary information prior to any account activity, the agency commented that the availability of this information is now widely publicized to investors for their use before opening an account and committing to buy or sell securities. Although we agree that this publicity is valuable, we also believe that SEC's original recommendation to require the disclosure of the availability of this information directly to individual investors when they are about to open an account would provide the information to the investor when it is of immediate use.

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As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 5 days after the date of issuance. At that time, we will send copies of this report to the Chairman, SEC and other interested parties. We will also make copies available to others upon request. Please contact me at (202) 512-8678 or Cecile O. Trop, Assistant Director, at (312) 220-7600 if you or your staff have any questions. Major contributors to this report are listed in appendix III.



Richard J. Hillman  
Associate Director, Financial Institutions  
and Markets Issues

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## Abbreviations

CRD	central registration database
EATS	Examination Activity Tracking System
IB	introducing broker
NASAA	North American Securities Administrators Association
NASD	National Association of Securities Dealers
NASDR	NASD Regulation
NSCC	National Securities Clearing Corporation
NYSE	New York Stock Exchange
OTC	over the counter
SEC	Securities and Exchange Commission
SRO	self-regulatory organization
STARS	Super Tracking and Reporting System



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# New, Amended, and Proposed SEC, NASD, and NYSE Rules Related to Microcap Fraud

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## SEC Amended Rule

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### Amendments To Regulation S

On February 17, 1998, the Securities and Exchange Commission (SEC) adopted amendments to Regulation S that are designed to prevent abuses related to offshore offerings of equity securities of domestic issuers. Regulation S 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. In abusing this safe harbor, issuers have illegally distributed securities in the United States and, in doing so, have denied investors the protections provided by registration under the Securities Act. Under the amendments, equity securities of U.S. issuers that are sold offshore under Regulation S would be 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 would be lengthened from 40 days to 1 year. SEC also adopted amendments that would affect applicable reporting requirements along with other amendments intended to prevent further abuses of Regulation S.

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## SEC Proposed Rules

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### Amendments to Rule 504 of Regulation D

On May 21, 1998, SEC proposed amendments to Rule 504 of Regulation D that would require all securities issued under the rule to be “restricted securities” and would allow their resale only after certain criteria were met. Rule 504 allows companies to raise up to \$1 million per year in “seed capital” without complying with Securities Act registration requirements. SEC is concerned that the freely tradable nature of securities issued in Rule 504 offerings may have facilitated a number of fraudulent market manipulations through the over-the-counter (OTC) Bulletin Board and National Quotation Bureau’s Pink Sheets. The comment period on these amendments expired on July 27, 1998.

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### Amendments to Rule 15c2-11

On February 17, 1998, SEC proposed amendments to Rule 15c2-11 that would require all broker-dealers to review issuer information before publishing quotations on non-Nasdaq OTC securities and require broker-dealers quoting a price to annually review updated issuer information. Rule 15c2-11 currently operates so that just the first market

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maker<sup>21</sup> in these stocks is required to review basic issuer information before publishing quotations for that issuer's securities. Other market makers may "piggyback" on the first market maker's quotes and publish quotes after 30 days without reviewing issuer information. Retail brokers "hyping" a microcap security may refer to a market maker's quotation when marketing a security to a potential customer. SEC is concerned that most market makers for unlisted securities publish quotations without reviewing current financial and other information on the issuer. The comment period for these amendments expired on April 27, 1998.

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### Amendments to Form S-8 and Related Rules

On February 17, 1998, SEC proposed amendments to Form S-8 and related rules that would restrict the use of the form for the sale of securities to consultants and advisors. 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. The amendments are designed to deter misuse of this form either by avoiding the Securities Act requirements that apply to securities sales to nonemployees or by issuing securities as compensation to stock promoters. Other proposed amendments would permit Form S-8 to be used by employees' family members for the exercise of stock options that employees give as gifts to their families. The comment period for these amendments expired on April 27, 1998.

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### Amendments or Plans Being Considered by SEC

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#### Amendments to Penny Stock Rules

Currently, the definition of "penny stock" excludes securities that, among other things, are priced at \$5 or more per share. However, SEC believes that some broker-dealers have circumvented the rules by pricing securities above the \$5 threshold. The SEC Chairman has testified that SEC is considering whether to recommend changing the penny stock rules to raise the price threshold to cover the types of securities that might be involved in microcap stock fraud.

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<sup>21</sup>Market makers are dealers who, with respect to a security, hold themselves out as being willing to buy and sell the security for their own accounts on a regular or continuous basis.

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**Plan for National Securities Clearing Corporation Reporting on Suspicious Transactions by Introducing Brokers**

Under a plan being discussed by the securities industry and SEC, the National Securities Clearing Corporation (NSCC)<sup>22</sup> would consolidate a variety of data received from clearing firms, SROS, and other sources. NSCC would use these data to identify suspicious activity by broker-dealers (introducing brokers (IB) and others), and this information would be made available to regulators.

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**NASD New and Amended Rules**

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**New Rule 2280**

On September 10, 1997, SEC approved NASD Rule 2280, effective January 1, 1998, which requires NASD members that carry customer accounts to provide customers in writing, at least once each calendar year, the NASD public disclosure program hotline number and web site address as well as a statement regarding the availability of an investor brochure describing the public disclosure program.

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**New Rule 2211**

On December 2, 1996, SEC approved NASD Rule 2211, effective December 2, 1996, that imposes time restrictions and disclosure requirements on telephone calls to customers by NASD members and their associated persons.

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**New Rule 3070**

On September 8, 1995, SEC approved NASD Rule 3070 for reporting customer complaint information and other specified events to NASDR. The rule, which became effective on October 15, 1995, requires that NASD members report to NASDR if any of 10 specified events occur and that they provide quarterly summary statistical information on written customer complaints.

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**New Rule 3110(g)**

On June 9, 1995, SEC approved NASD Rule 3110(g), or “cold calling” rule, effective June 9, 1995, consistent with rules of the Federal Communication Commission promulgated under the Telephone Consumer Protection Act, which require telemarketers to establish and maintain a list of persons who have requested that they not be contacted by the telemarketer (do-not-call list).

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<sup>22</sup>NSCC, owned jointly by the New York Stock Exchange (NYSE), the National Association of Securities Dealers (NASD), and the American Stock Exchange, clears 98 percent of all stock and bond transactions in the United States.

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**New Rule 1120**

On February 8, 1995, SEC approved NASD's membership and registration Rule 1120 to implement the Securities Industry Continuing Education Program, which became effective July 1, 1995. The rule required all registered persons to take computer-based training within 120 days of their second, fifth, and tenth registration anniversaries. Effective July 1, 1998, this training is required every 3 years.

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**Amendment to Rule 3010**

On April 17, 1998, SEC approved an NASD amendment to Rule 3010 that requires an NASD member firm to tape record conversations between customers and registered representatives if it hired a significant percentage of individuals (dependent on firm size) from disciplined firms.

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**Amendment to Rule 8310**

On January 20, 1998, SEC approved an amendment to Interpretive Memo 8310-2 (Release of Disciplinary Information), which allowed for the release of additional disciplinary information that is required to be disclosed pursuant to amended forms U-4, U-5, and BD, including, but not limited to (1) customer-initiated arbitrations that are pending or settled (for \$10,000 or more), (2) civil proceedings and written customer complaints (within certain dollar limits), (3) current investigations involving criminal or regulatory matters, and (4) bankruptcies less than 10 years old. The rule also was amended to allow NASDR to respond to electronic requests for information. Amendments in 1993 allowed for the release of pending formal SRO disciplinary actions, criminal indictments, civil judgments, and final judgments in arbitration decisions.

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**NASD Proposed Rules**

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**Rules 2315 and 2360**

In July 1998, NASD filed proposed Rules 2315 and 2360, which would, respectively, require NASD members to (1) review current issuer financial statements prior to recommending a transaction to a customer in an unlisted equity security and (2) provide a disclosure statement to a customer on each customer's confirmation following any trade of an unlisted equity security. SEC has not yet published the proposals for public comment.

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**Amendments to Rules 6530 and 6540**

In July 1998, NASD filed an amendment to Rule 6530 to limit quotations on the OTC Bulletin Board to the securities of issuers that are current in

reports to be filed with SEC or other regulatory authorities and a companion Rule 6540 that would prohibit an NASD member from quoting a security on the OTC Bulletin Board unless the issuer's filings are current. SEC has not yet published the proposals for public comment.

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**Interpretation of Rule 3010  
and Amendment to Rule  
1060**

In July 1998, NASD filed a proposed interpretation to Rule 3010 and an amendment to Rule 1060 that would limit the kinds of cold calls that may be made by unregistered persons and impose obligations on member firms to supervise these employees. However, in its description of the proposal, NASD states that "the proposed rule change would permit members to use third-party telemarketing firms" to make cold calls on behalf of the member firm. SEC has not yet published the proposal for public comment.

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**Rule 1150**

On April 21, 1998, NASD filed proposed Rule 1150 with SEC to provide NASD members with qualified immunity in arbitration proceedings for statements made in good faith in certain required disclosures filed with NASD on forms U-4 and U-5, the uniform registration and termination notices for registered persons, respectively. The comment period expired on June 19, 1998.

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**Rule 3230**

On November 21, 1997, SEC published for comment a proposed change to NASD Rule 3230 that would require clearing firms to (1) forward customer complaints about an IB to the IB and the IB's designated examining authority, (2) notify complaining customers that they have the right to transfer their accounts to another broker-dealer, (3) provide IBs with a list of exception reports to help them supervise their activities, and (4) assume liability for any mistakes or fraud made by an IB that issues checks drawn on the clearing firm's account. The comment period expired on December 22, 1997.

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**NYSE Proposed Rule**

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**Amendment to Rule 382**

NYSE proposed an amendment to Rule 382 on September 16, 1997, that is similar to proposed NASD Rule 3230. The comment period has expired.

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# Comments From SEC

Note: GAO comment supplementing those in the report text appears at the end of this appendix.



DIVISION OF  
MARKET REGULATION

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

August 28, 1998

Mr. Richard J. Hillman  
Associate Director, Financial  
Institutions and Markets Issues  
United States General Accounting Office  
441 G Street N.W.  
Washington, D.C. 20548

Dear Mr. Hillman:

This letter responds to your letter dated August 10, 1998, requesting our review of the draft Report entitled SEC: Actions Reported on GAO and SEC Recommendations Related to Microcap Stock Fraud.

Thank you for the opportunity to comment on the draft Report. I am enclosing a copy of the draft Report with minor handwritten comments on the tabbed pages and am attaching a page containing inserts that update sections of the Report's Appendix.

As the Report notes, the SEC and the self-regulatory organizations (SROs) have implemented most of the recommendations in prior GAO and SEC reports that address issues related to microcap stock fraud. The Report at page 11 notes that four recommendations have not been fully implemented.

Reporting and Trend Analysis of Violations Found in Examinations. The Report reiterates a 1991 recommendation that the SEC explore ways to record and maintain information on the number of each type of violation found during onsite examinations of broker-dealers and include this information in its examination tracking system. Staff from the Office of Compliance Inspections and Examinations (OCIE), in conjunction with the Office of Information Technology, are working to develop an examination tracking system to replace its current broker-dealer examination tracking system by FY 2000. In May 1998, a *requirements analysis* was completed for a new examination tracking system called the Super Tracking and Reporting System (STARS). As a tool for identifying and analyzing trends in violations, STARS will enable home and regional office staff to make *ad hoc* queries of the database and will interface with other Commission databases. For instance, SEC staff will be able to query the number of firms within the State of New York that have been cited in examinations for books and records violations or fraudulent conduct.

The Report notes that STARS will not be designed to capture data on the number of times each type of rule violation occurred (e.g., the number of trades, records, or accounts). The staff believes that quantifying the number of times a violation is documented in

See comment.

Mr. Richard J. Hillman  
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examinations of broker-dealers would add complexity in operating STARS without enhancing the staff's ability to analyze trends in violations. A comparison of the number of times a violation is found at different firms would not be meaningful because sample sizes and review periods vary in every examination, depending on the firm's business, size, and compliance history. More meaningful indicators of the significance and extent of violations are the monetary value and the period over which violations occurred, but only when viewed in the context of all the relevant facts and circumstances. Therefore, the staff believes that this information cannot be reduced to a statistical summary. However, in order to gather more information about the significance and extent of violations found in examinations, OCIE will be storing the full text of all reports on the *Zyindex* system. This system will enable the staff to conduct searches of all reports using keywords and to compile an analysis of the information.

See p. 8.

Broker Migration. The Report also states that, with respect to the migration of unscrupulous brokers from the securities industry to other financial services industries, the banking regulators had proposed a rule that would have required banks to report the hiring of brokers to the CRD and for brokers hired by banks to take NASD qualification exams. In response, the NASD in a letter dated June 10, 1998, expressed concern to the banking regulators about this proposal because: (1) the NASD exams focus on knowledge of and compliance with securities regulations, and bank employees are not required to comply with these regulations; and (2) the public may be led to assume that because a bank employee had taken an NASD examination, the bank securities activity is subject to the same comprehensive securities regulation that applies to an NASD member firm. The NASD offered to assist the bank regulators in developing an alternative examination for bank employees and their supervisors tailored to the bank regulatory environment and reiterated its support for the use of the CRD to make publicly available the complaint and disciplinary records of bank securities personnel.

See p. 12.

Disclosure of Disciplinary History. The Report also notes that the SEC's large firm report recommended that information on the availability of a broker's disciplinary history through the NASD's toll-free hotline be disclosed to investors before any activity occurs in their accounts. The GAO suggested this information could be included on account-opening documents or account statements. Instead of including the NASD's toll-free hotline number in the account-opening documents, the NASD, the SEC, NASAA, and others have widely publicized the availability of the NASD's toll-free number to encourage investors to investigate brokers *before* opening an account and committing to buy or sell securities. Moreover, information about a broker's disciplinary history is accessible on the Internet through the NASD's website.

See p. 9.

Central Registration Database. The Report notes that technology improvements have delayed the central registration database (CRD) project. As noted above, the information about a broker's disciplinary history is now more readily available through the Internet. In addition, the NASD, together with the SEC and North American Securities Administrators Association (NASAA), has made significant progress towards upgrading the CRD to improve oversight of



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Page 3

problem brokers. Although the upgrades have not been completed, the NASD is devoting significant resources to the project. We will continue to work closely with the NASD to ensure that this important project is completed as soon as technologically feasible.

Other Actions. We are taking a variety of actions to address microcap fraud in addition to those included in the GAO recommendations. Many of these initiatives are noted in the Appendix to the Report. We also are working with the securities industry to develop other measures to reduce microcap fraud. For example, based on a suggestion by SEC staff, an industry group including the Securities Industry Association, the National Securities Clearing Corporation (NSCC), and others are discussing a plan whereby the NSCC would gather data from a variety of sources on potentially suspicious activity by broker-dealers and their customers, and forward this information to regulators.

Combatting microcap fraud continues to be a high priority for the Commission and the SROs. The accomplishments and ongoing efforts discussed in the Report and above reflect this commitment. We look forward to continued progress in this important area of investor protection.

If you would like an oral briefing on our comments, or if you have any questions, please contact me at (202) 942-0770 or Nancy J. Sanow at (202) 942-0771.

Sincerely,



Larry E. Bergmann  
Senior Associate Director

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The following is GAO's comment on the August 28, 1998, letter from the Securities and Exchange Commission.

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**GAO Comment**

Based on discussions with SEC staff to further clarify the intent of our recommendation and the capabilities of SEC's planned system enhancements, we revised the text of the report. The report now recognizes that, if implemented as described, SEC's planned enhancements to its systems capabilities would be consistent with the intent of our recommendation. The intent of our recommendation was that SEC be capable of identifying, across firms, trends in violations found during its broker-dealer examinations that could warrant greater regulatory attention.

# Major Contributors to This Report

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