submits the quotation to the quotation medium, *Provided* That the offering circular provided for under Regulation A has not thereafter become the subject of a suspension order which is still in effect when the quotation is published or submitted; or

(3) A copy of the issuer's most recent annual report filed pursuant to section 13 or 15(d) of the Act or a copy of the annual statement referred to in section 12(g)(2)(G)(i) of the Act, in the case of an issuer required to file reports pursuant to section 13 or 15(d) of the Act or an issuer of a security covered by section 12(g)(2)(B) or (G) of the Act, together with any quarterly and current reports that have been filed under the provisions of the Act by the issuer after such annual report or annual statement; *Provided, however,* That until such issuer has filed its first annual report pursuant to section 13 or 15(d) of the Act or annual statement referred to in section 12(g)(2)(G)(i) of the Act, the broker or dealer has in its records a copy of the prospectus specified by section 10(a) of the Securities Act of 1933 included in a registration statement filed by the issuer under the Securities Act of 1933, other than a registration statement on Form F–6, that became effective within the prior 16 months, or a copy of any registration statement filed by the issuer under section 12 of the Act that became effective within the prior 16 months, together with any quarterly and current reports filed thereafter under section 13 or 15(d) of the Act; and *Provided further,* That the broker or dealer has a reasonable basis under the circumstances for believing that the issuer is current in filing annual, quarterly, and current reports filed pursuant to section 13 or 15(d) of the Act, or, in the case of an insurance company exempted from section 12(g) of the Act by reason of section 12(g)(2)(G) thereof, the annual statement referred to in section 12(g)(2)(G)(i) of the Act; or

(4) The information furnished to the Commission pursuant to § 240.12g3–2(b) since the beginning of the issuer's last fiscal year, in the case of an issuer exempt from section 12(g) of the Act by reason of compliance with the provisions of § 240.12g3–2(b), which information the broker or dealer shall make reasonably available upon request to any person expressing an interest in a proposed transaction in the security with such broker or dealer; or

(5) The following information, which shall be reasonably current in relation to the day the quotation is submitted and which the broker or dealer shall make reasonably available upon request to any person expressing an interest in a proposed transaction in the security with such broker or dealer:

(xvi) * * *

If such information is made available to others upon request pursuant to this paragraph, such delivery, unless otherwise represented, shall not constitute a representation by such broker or dealer that such information is accurate, but shall constitute a representation by such broker or dealer that the information is reasonably current in relation to the day the quotation is submitted, that the broker or dealer has a reasonable basis under the circumstances for believing the information is accurate in all material respects, and that the information was obtained from sources which the broker or dealer has a reasonable basis for believing are reliable. This paragraph (a)(5) shall not apply to any security of an issuer included in paragraph (a)(3) of this section unless a report or statement of such issuer described in paragraph (a)(3) of this section is not reasonably available to the broker or dealer. A report or statement of an issuer described in paragraph (a)(3) of this section shall be "reasonably available" when such report or statement is filed with the Commission.

(b) With respect to any security the quotation of which is within the provisions of this section, the broker or dealer submitting or publishing such quotation shall have in its records the following documents and information:

(1) A record of the circumstances involved in the submission of publication of such quotation, including the identity of the person or persons for whom the quotation is being submitted or published and any information regarding the transactions provided to the broker or dealer by such person or persons;

(2) A copy of any trading suspension order issued by the Commission pursuant to section 12(k) of the Act respecting any securities of the issuer or its predecessor (if any) during the 12 months preceding the date of the publication or submission of the quotation, or a copy of the public release issued by the Commission announcing such trading suspension order; and

(3) A copy or a written record of any other material information (including adverse information) regarding the issuer which comes to the broker's or dealer's knowledge or possession before the publication or submission of the quotation.

(c) The broker or dealer shall preserve the documents and information required under paragraphs (a) and (b) of this section for a period of not less than three years, the first two years in an easily accessible place.

(d)(1) For any security of an issuer included in paragraph (a)(5) of this section, the broker or dealer submitting the quotation shall furnish to the interdealer quotation system (as defined in paragraph (e)(2) of this section), in such form as such system shall prescribe, at least 3 business days before the quotation is published or submitted, the information regarding the security and the issuer which such broker or dealer is required to maintain pursuant to said paragraph (a)(5) of this section.

(2) For any security of an issuer included in paragraph (a)(3) of this section,

(i) a broker-dealer shall be in compliance with the requirement to obtain current reports filed by the issuer if the broker-dealer obtains all current reports filed with the Commission by the issuer as of a date up to five business days in advance of the earlier of the date of submission of the quotation to the quotation medium and the date of submission of the paragraph (a) information pursuant to Schedule H of the By-Laws of the National Association of Securities Dealers, Inc.; and

(ii) a broker-dealer shall be in compliance with the requirement to obtain the annual, quarterly, and current reports filed by the issuer, if the broker-dealer has made arrangements to receive all such reports when filed by the issuer and it has regularly received reports from the issuer on a timely basis, unless the broker-dealer has a reasonable basis under the circumstances for believing that the issuer has failed to file a required report or has filed a report but has not sent it to the broker-dealer.

* * * * *

(f) * * *

(5) The publication or submission of a quotation respecting a security that is authorized for quotation in the NASDAQ system (as defined in § 240.11Ac1–2(a)(3) of this chapter), and such authorization is not suspended, terminated, or prohibited.

* * * * *

By the Commission.

Dated: April 17, 1991.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 91–9415 Filed 4–24–91; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-29095; File No. S7-9-91]

RIN: 3235-AD94

Initiation or Resumption of Quotations Without Specified Information

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rulemaking.

SUMMARY: The Commission is publishing for comment amendments to Rule 15c2-11 under the Securities Exchange Act of 1934. Rule 15c2-11 governs the submission and publication of quotations by brokers and dealers for certain over-the-counter securities ("covered securities"). With certain exceptions, the Rule prohibits a broker or dealer from publishing a quotation for a covered security in a quotation medium unless it has in its records and reviews specified information concerning the security and the issuer. One exception, commonly known as the "piggyback exception," currently permits a broker-dealer to publish quotations without having the required information when the security has been the subject of recent and frequent interdealer quotations by the firm itself ("self-piggybacking") or other firms.

The proposed amendments would substantially narrow the scope of the piggyback exception, so that only self-piggybacking would be excepted under defined conditions and every broker and dealer generally would be required to obtain and review the specified information before it initiates or resumes a quotation for a covered security. Alternatively, the Commission is considering a total repeal of the piggyback exception. In light of the current recordkeeping requirements of the Rule, and since either modification or repeal of the piggyback exception would increase those costs for some firms, the Commission is also proposing an amendment to the Rule which would encourage the creation of one or more central information repositories by permitting broker-dealers, under certain conditions, to rely on the presence of required issuer information in such a repository instead of maintaining those files internally.

The Commission has provided for an extended comment period in order to obtain the views of broker-dealers that have had experience with the operation of the Rule following the adoption today of amendments relating to a broker-dealer's information gathering and review requirements.

DATES: Comments must be received on or before January 1, 1992.

ADDRESSES: Interested persons should submit three copies of their written data, views, and arguments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549, and refer to File No. S7-9-91. All submissions will be available for public inspection and copying in the Commission's Public Reference Branch, 450 Fifth Street, NW., Washington, DC 20549.

FOR FURTHER INFORMATION CONTACT: Nancy J. Sanow or Jodie Kelley, Office of Trading Practices, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549, telephone (202) 272-2848.

SUPPLEMENTARY INFORMATION:

I. Background

A. Prior Commission Action

The Securities and Exchange Commission ("Commission") is proposing amendments to Rule 15c2-11 ("Rule 15c2-11" or "Rule") [1] under the Securities Exchange Act of 1934 ("Exchange Act").[2] This proposal results from comments received in response to a release published in September 1989 soliciting public comment concerning the merits of the Rule's "piggyback exception" [3] and the concept of establishing a central repository for the information required by the Rule.[4] Specifically, the Commission inquired as to whether the piggyback exception should be retained, reformulated, or eliminated, and whether the use of a central repository could be a more efficient means of assembling and retrieving the required information. Sixteen commenters provided written views.[5] The further amendments to the Rule proposed in this release are based on the Commission's review of these responses [6] and represent an additional step in its ongoing efforts to combat abuses in the non-NASDAQ stock markets.

B. Operation of Current Rule 15c2-11 and the Piggyback Exception

Rule 15c2-11 regulates the publication by a broker or dealer of quotations in a quotation medium [7] for certain over-the-counter securities. Adopted in 1971,[8] the

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[1] 17 CFR 240.15c2-11.

[2] 15 U.S.C. 78a *et seq.*

[3] See Securities Exchange Act Release No. 27247 (September 14, 1989), 54 FR 39194 (September 25, 1989) ("the 1989 Release"). The 1989 Release also requested comment on a number of proposed amendments to the Rule. The Commission issued the 1989 Release as part of the continuing effort of the Commission's Penny Stock Fraud Task Force to respond to increasing reports of fraud and manipulation in the penny stock market. See, *e.g.*, the 1989 Release, 54 FR at 39195.

Penny stocks are low-priced, over-the-counter ("OTC") securities that often are quoted in the National Daily Quotation Service, also known as the "pink sheets," which is published and distributed nationally in printed form by the National Quotation Bureau, Inc. It has been the principal interdealer quotation system for equity securities that are neither listed for trading on an exchange nor authorized for inclusion in the NASDAQ system operated by the National Association of Securities Dealers, Inc. ("NASD"). Other printed quotation media are distributed in limited geographical areas, *e.g.*, the Regional Inter-Dealer Over-the-Counter Stock Quotations prepared by Metro Data Company in Minneapolis, Minnesota (known as the "white sheets"). Also, the Commission recently approved an NASD proposal to operate nationally the OTC Bulletin Board Display Service ("OTC Service") on a pilot basis. The OTC Service is designed to capture and display electronically real-time quotations of market makers in non-NASDAQ securities. Securities Exchange Act Release No. 27975-A (May 30, 1990), 55 FR 23161 ("Release 34-27975-A"), SEC File No. SR-NASD-88-19. In this release, the OTC securities quoted in these quotation media are referred to as "non-NASDAQ securities," and the markets in which these securities are traded are referred to as the "non-NASDAQ market."

[4] See the 1989 Release, 54 FR at 39202-39204 and Section II, *infra*. In a companion release, the Commission today is adopting, with certain modifications, the proposed amendments described in the 1989 Release. Securities Exchange Act Release No. 29094 (April 17, 1991) ("Release 34-29094").

[5] The letters of comment, together with a Summary of Comments prepared by the Commission's staff, are included in File No. S7-27-89 and are available for review and copying in the Commission's Public Reference Room.

[6] The Commission also considered comments received in response to Securities Exchange Act Release No. 21914 (April 1, 1985), 50 FR 14111 ("Release 34-21914"). A summary of these comments, which related to the costs and benefits of the Rule, has been prepared by the staff and is available for inspection and copying in File No. S7-14-85.

[7] The term "quotation medium" is defined in paragraph (e)(1) of the Rule, 17 CFR 240.15c2-11(e)(1), to include any interdealer quotation system or any publication or electronic communications network or other device used by broker-dealers to make known their interest in transactions in any security. The term "interdealer quotation system" is defined in paragraph (e)(2) of the Rule, 17 CFR 240.15c2-11(e)(2), to mean "any system of general circulation to brokers or dealers which regularly disseminates quotations of identified brokers or dealers."

[8] See Securities Exchange Act Release No. 9310 (September 13, 1971), 36 FR at 18641 ("Release 34-9310"). Rule 15c2-11 was adopted under Section 15(c)(2) of the Exchange Act, 15 U.S.C. 78o(c)(2), among other sections. Section 15(c)(2) provides the Commission with broad authority to promulgate rules that prescribe means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices in the over-the-counter market.

Rule is designed primarily to prevent certain manipulative and fraudulent trading schemes that had arisen initially in connection with the distribution and trading of securities issued by "shell" companies (*i.e.*, companies with few or no assets) [9] or other issuers having outstanding but infrequently-traded securities. The Rule is intended to prevent brokers and dealers from disseminating quotations in the absence of information about the issuer, an activity that has been critical to the success of many of the unlawful schemes.[10] The Rule focuses on the fraudulent and manipulative potential of quotations. A violation of the Rule may occur regardless of whether the broker-dealer also is engaged in retail activity in the security,[11] or whether any interdealer transactions have occurred.[12]

Subject to certain exceptions,[13] the Rule prohibits a broker or dealer from submitting a quotation [14] for publication in a quotation medium unless it has in its records specified information concerning the security and the issuer. The broker or dealer must have in its records: (1) In the case of an issuer that has conducted a recent public offering registered under the Securities Act of 1933 ("Securities Act") [15] or qualified pursuant to Regulation A under the Securities Act,[16] a copy of the pertinent prospectus [17] or offering circular;[18] or (2) in the case of an issuer that must file reports pursuant to sections 13 [19] or 15(d) [20] of the Exchange Act or is an insurance company of the kind specified in section 12(g)(2)(G) of the Exchange Act,[21] the issuer's most recent annual report and any periodic and current reports filed thereafter;[22] or (3) in the case of foreign issuers exempt from Section 12(g) of the Exchange Act, the information furnished to Commission pursuant to Rule 12g3-2(b) [23] under the Exchange Act.[24] In order to submit a quotation for the security of an issuer that does not fall into one of the above categories, the broker or dealer must have in its records the information, including certain financial information, specified in paragraph (a)(5) of the Rule.[25]

The broker or dealer must review the foregoing information (*i.e.*, "paragraph (a) information"), together with other information regarding the issuer in the broker-dealer's knowledge on possession,[26] and, based on such review, have a reasonable basis for believing that the paragraph (a) information is accurate and that it was obtained from reliable sources.[27]

Under paragraph (f)(3),[28] the piggyback exception, the Rule's information maintenance requirements are not applicable when a broker or dealer enters, in an interdealer quotation system,[29] a quotation for a security that has been the subject of quotations by the firm or other broker-dealers on at least 12 business days during the previous 30 calendar days, with no more than four consecutive business days elapsing without any quotations. As a result, until 30 calendar days have elapsed from the date of publication of the initial broker-dealer's quotation, no broker-dealer may publish a quotation unless it has satisfied the information requirements.[30] After the 30-day period, a broker-dealer may publish a quotation without having the required information if the 12 and 4 day tests are satisfied (*i.e.*, the broker-dealer may "piggyback" on the previously published quotations). The piggyback exception assumes that the quotation of a security subject to regular and frequent two-sided market making will reflect independent supply and demand forces.[31]

Consequently, the Rule's information requirements apply only upon "initiation or resumption" [32] of a quotation in a quotation medium for a security that has not been quoted with the required frequency during the previous 30 days. Rule 15c2-11 therefore does not require any broker-dealer to obtain updated

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[9] Rule 15c2-11 was intended to address a variety of questionable practices involving a "spin-off" or other distribution to the public of the securities of a shell corporation and the subsequent active trading of those shares at increasingly higher prices that bore no relation to the value of the securities. See Release 34-9310, 36 FR at 18641.

[10] Release 34-9310, 36 FR at 18641. As to the scope and objectives of the Rule, see also Securities Exchange Act Release No. 21470 (November 15, 1984), 49 FR 45117 ("Release 34-21470") [adopting amendments to Rule 15c2-11) and Release 34-29094. The Rule "seeks to guard against 'the fraudulent and manipulative potential inherent * * * when a * * * dealer submits quotations concerning any infrequently-traded security in the absence of certain information.'" *Gotham Securities Corporation*, 46 SEC 723, 725 (1976), *citing* Release 34-9310.

[11] See *Alessandrini & Co., Inc.*, 45 SEC 399, 401. The objective in having quotations published for a security may not be to trade the security, but to establish an apparent value for the security. Apparent value is important, for example, where the security is serving as collateral for loans. See, *e.g.*, id. at 400.

[12] See *Richfield Securities, Inc.*, Securities Exchange Act Release No. 26129 (September 29, 1988), 41 SEC Docket (CCH) 1235.

[13] In addition to the piggyback exception, discussed *infra*, the Rule excepts from its coverage publication or submission of a quotation in the OTC market for a security admitted to trading on a national securities exchange (if traded on that exchange on the same day or on the day before submission of the quotation), or a security authorized for quotation in the NASDAQ system operated by the National Association of Securities Dealers, Inc. ("NASD"). See paragraphs (f)(1) and (f)(5) of the Rule, respectively, 17 CFR 240.15c2-11 (f)(1) and (f)(5). As a result, the Rule's focus is the residual OTC market, or the "non-NASDAQ market." See *supra* n.3.

Paragraph (f)(2) of the Rule, 17 CFR 240.15c2-11(f)(2), contains a further exception where a quotation is submitted solely to represent an unsolicited customer interest in buying or selling a covered security. However, two-way (bid and asked) priced quotations representing an unsolicited customer interest are not excepted unless identified as such in the quotation medium. See section II, *infra*.

[14] "Quotation" is defined in paragraph (e)(3) of the Rule, 17 CFR 240.15c2-11(e)(3), to include any advertisement by a broker or dealer that he wishes to buy or sell a particular security at a specified price or otherwise. In 1984, the Commission expanded the definition of quotation to include the publication by broker-dealers of trading interest in a security without specifying the prices at which the broker-dealer would engage in those transactions ("name-only entries"). Release 34-21470, 49 FR at 45119.

[15] 15 U.S.C. 77a *et seq.*

[16] 17 CFR 230.251 *et seq.*

[17] 17 CFR 240.15c2-11(a)(1) [registration statement must have become effective within the preceding 90 calendar days).

[18] 17 CFR 240.15c2-11(a)(2) [notification regarding the offering must have become effective within the preceding 40 calendar days).

[19] 15 U.S.C. 78m.

[20] 15 U.S.C. 78*o*(d).

[21] 15 U.S.C. 78*l*(g)(2)(G).

[22] 17 CFR 240.15c2-11(a)(3). In the case of an issuer that has become a reporting issuer but has not filed its first annual report, it may now satisfy this paragraph by having in its records certain other previously filed materials. See Release 34-29094.

[23] 17 CFR 240.12g3-2(b).

[24] 17 CFR 240.15c2-11(a)(4).

[25] 17 CFR 240.15c2-11(a)(5). Paragraph (a)(5) also provides: "This paragraph (a)(5) shall not apply to any security of an issuer included in paragraph (a)(3) of this section unless a report is not reasonably available to the broker or dealer. A report or statement of an issuer described in paragraph (a)(3) of this section shall be 'reasonably available' when such report or statement is filed with the Commission."

[26] See 17 CFR 240.15c2-11(b). This includes Commission orders or releases relating to summary suspensions of trading in any of the issuer's securities during the preceding 12 months.

[27] Release 34-29094.

[28] See 17 CFR 240.15c2-11(b). This includes Commission orders or releases relating to summary suspensions of trading in any of the issuer's securities during the preceding 12 months.

[29] Release 34-29094.

[30] 17 CFR 240.15c2-11(f)(3).

[31] See *supra* n.7.

[32] See Release 34-9310, 36 FR at 18641 n.2. Moreover, unless the interdealer quotation system specifically identifies quotations that represent unsolicited customer indications of interest, a broker-dealer may piggyback only where a security has been the subject of both bid and ask quotations at specified prices for the time periods enumerated in the Rule. Compare paragraph (f)(3)(i) with paragraph (f)(3)(ii).

[33] See Release 34-21470, 49 FR at 45121, and section II, infra.

[34] If the Commission repeals the piggyback exception, as discussed in Section II, *infra*, the title of the Rule, which contains the quoted language, would be modified to reflect the impact of the amendment.

information about the issuer or its securities as long as the piggyback exception applies to the quotation. In particular, the Rule permits "self-piggybacking," or the ability of a firm to continue making a market indefinitely, on the basis of its own prior quotations, without any requirement that the firm seek to update its issuer information files.[33]

C. The Commission's Request in the 1989 Release for Comments Concerning the Piggyback Exception

1.Issues Presented

In the 1989 Release, the Commission stated its concern that, under present circumstances, permitting broker-dealers to piggyback on existing quotations for a security may be undermining, and may be inconsistent with, the fundamental goals of the Rule. In that regard, the Commission noted that the piggyback exception has been based upon a premise that the market for a security subject to regular and frequent quotations by market makers usually will reflect independent supply and demand forces and thus lead to fair pricing of the subject securities. The deeper premise of this view, the Commission observed, appears to be that trading solely on the basis of perceived indications of supply and demand without having basic information about the issuer is an appropriate market making function.[34]

The Commission questioned whether these premises continued to have vitality in light of developments since the Rule's adoption. When the Rule was adopted, it covered a broad spectrum of OTC securities, including a very large number of widely-followed stocks subject to regular two-way priced quotations by multiple competing market makers. To a major extent, trading interest (*i.e.*, supply and demand forces) could be gauged from such quotations, and they could be used as a guide to pricing decisions of investors and other professionals. Today, the Rule applies principally to the non-NASDAQ market, predominantly consisting of infrequently-traded, relatively unknown securities with unpriced quotation entries and little or no competition among market makers.[35]

The Commission therefore expressed its concern that the piggyback provision can result in market makers unwittingly facilitating fraudulent schemes in that their introduction of quotations can add credibility to the illusion of a legitimate market for the securities involved. The Commission concluded preliminarily that removing the piggyback exception, thereby extending the Rule's information gathering and review requirements to all participating market makers, would further the efficient valuation of non-NASDAQ securities and increase the likelihood that fraudulent schemes would be quickly exposed.[36]

The Commission also noted that, at least for firms engaged in a retail business, the elimination of the piggyback exception should impose no new burdens. Because such firms must have a reasonable basis for any recommendations to customers, they have an obligation to be familiar with material information about issuers of any recommended security for which they also make markets.[37]

In addition, the Commission pointed to the difficulty that broker-dealers may have in determining whether the conditions for availability of the piggyback exception have been satisfied.[38] Because the pink sheets, for example, are disseminated in paper format, the broker-dealer is required to have available and review a month's collection of pink sheet quotations before initiating or resuming a quotation.[39] As a consequence, the Commission understands that some market makers ignore the piggyback exception and obtain the required information about the issuer in all cases.[40]

2. Comments Received

A total of 16 commenters responded to the Commission's inquiries on the piggyback exception.[41] Six commenters supported retention of the piggyback exception. They indicated that the provision is a major feature of the Rule and is relied upon by many market participants. Some of these commenters suggested that if the exception were eliminated or materially limited, broker-dealers might decide that it was uneconomical to continue making markets for many non-NASDAQ securities.

Four commenters specifically supported retaining the ability of broker-dealers to self-piggyback. Some of these commenters noted that elimination of the ability to self-piggyback would place financial and administrative burdens on market makers to gather the required information, and would contribute to a cessation of market making, reduced liquidity, and thus impaired valuation for many non-NASDAQ securities.

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[33] Many market makers update their information routinely to keep abreast of developments affecting the issuer, to satisfy other obligations under the securities laws (*e.g.*, the need to have a reasonable basis when recommending securities to customers), and to satisfy suitability requirements. See, *e.g.*, *Hanly* v. *SEC*, 415 F.2d 589 (2d Cir. 1969), *affirming Richard J. Buck & Co.*, 43 S.E.C. 998 (1968); *see also* Securities Exchange Act Release No. 26100 (September 22, 1988), 53 FR 37778, 37787, and cases cited therein. The Commission has stated that the Rule "is not intended to, and does not, excuse brokers and dealers from their duty to comply with applicable registration and other anti-fraud provisions of the federal securities laws and Commission rules." Release 34-9310, 36 FR at 18641. *See also*, New York Stock Exchange Rule 405, NYSE Guide (CCH) ¶2405; NASD Rules of Fair Practice, Art. III, Sec. 2, NASD Manual (CCH) ¶2152.

[34] 54 FR at 39202. In discussing this trading "by the numbers," the Commission has cautioned that—"when * * * a dealer [has] no basis on which those numbers could be related to the security's investment value, careful scrutiny of all surrounding circumstances with a view to detecting any sign of possible manipulation [is] called for."

Alessandrini, *supra* n.11, at 405. See also Release 34-29094.

[35] *See infra* nn.44-45 and accompanying text.

[36] 54 FR at 39203. In responding to the Commission's requests for comments on then proposed Rule 15c2-6 under the Exchange Act, see Securities Exchange Act Release No. 26529 (February 8, 1989), 54 FR 6693, a number of commenters indicated that broker-dealers that publish quotations for non-NASDAQ securities without having information about the issuer may be contributing to the "penny stock fraud" phenomenon. These commenters suggested that the Commission consider eliminating the Rule 15c2-11 piggyback exception. See, *e.g.*, letter from American Bar Association, Section of Business Law, Committee on Federal Regulation of Securities, Subcommittee on Broker-Dealer Matters, to Jonathan G. Katz, Secretary, SEC (April 25, 1989); letter from Frank J. Wilson, Executive Vice President and General Counsel, NASD (June 15, 1989). Other commenters on proposed Rule 15c2-6 similarly pointed to the lack of issuer information available to potential investors in non-NASDAQ securities. These commenters suggested that Rule 15c2-11 type information should be available to prospective investors, and the information could be supplied by broker-dealers that recommend the purchase of such securities. *See, e.g.*, letter from Lowy & Chernis, P.C., to SEC, Division of Market Regulation (May 11, 1989); letter from Malone & Associates, Inc., to Jonathan G. Katz, Secretary, SEC (March 29, 1989). These comment letters are contained in File No. S7-3-89 in the Commission's Public Reference Room.

[37] *See, e.g.*, letter from Sutro & Co. Incorporated to John Wheeler, Secretary, SEC (June 7, 1985), and letter from Blinder Robinson & Co., Inc. to John Wheeler, Secretary, SEC (June 4, 1985), included in File No. S7-14-85. *See also supra* n.33.

[38] See supra text accompanying nn. 28-30.

[39] At this time, it is unclear what impact the development of the NASD's OTC Service may have on the ability of participants in that system to determine whether the Rule's piggyback conditions have been satisfied.

[40] Additionally, the Commission restated its long-held concern relating to the incidence of non-compliance with the conditions of the piggyback exception. It was noted, however, that the National Quotation Bureau had initiated new monitoring procedures. 54 FR at 39203, n.102. Further, following the 1989 Release, the NASD established procedures for overseeing member compliance with the provision. *See* Securities Exchange Act Release No. 27968 (May 5, 1990), 55 FR 19132, File No. SR-NASD-90-2. In the case of the OTC Service, the NASD has developed special compliance procedures. See Release 34-27975-A, 55 FR at 23165.

[41] *See supra* n.5.

Seven commenters favored elimination or some modification of the current piggyback exception. Four of these commenters believed that the exception could be eliminated for retail broker-dealers, but favored maintaining the ability of wholesale broker-dealers to piggyback. Two commenters stated that the piggyback exception was inconsistent with the fundamental purposes of the Rule. One of these commenters, the NASD, believed that all market makers should be required to obtain the prescribed information from a reliable source and to conduct a basic review of that information as a condition to commencing quotations in non-NASDAQ securities. The NASD stated that elimination of the piggyback provision should result in more competitive and efficient pricing of these securities by market makers. The NASD expressed concern that the current piggyback provision could be relied upon by a broker-dealer entering the quotation medium as an accommodation to another broker-dealer or in facilitation of a fraudulent scheme. The NASD argued that the original justification for the exception (*i.e.*, that regular and frequent two-sided priced quotations reflect independent supply and demand forces) no longer exists because of the prevalence of name-only (unpriced) entries in these markets.

Fourteen commenters supported creation of a central repository of Rule 15c2–11 information. The NASD, which had been among the first to suggest the concept of a central repository,[42] stated that any initiatives respecting an electronic repository should be left to providers of commercial research services and that formal consideration of such a repository should be deferred until the Commission's Electronic Data Gathering, Analysis and Retrieval system (EDGAR) program is fully implemented.[43]

[42] See letter from NASD to John Wheeler, Secretary, SEC, dated December 16, 1985, included in File No. S7–14–85. The NASD also commented that while the existence of a repository would ease the compliance burden for market makers, it should not relieve them of the obligation reasonably to determine that the information on record is complete, current, and obtained from a reliable source. The NASD argued that, absent an alternative means of certifying that the repository's files satisfy these aspects of the Rule, the fact that a broker-dealer had access to that file should not satisfy a broker-dealer's review obligations under the Rule.

[43] *Cf.* 54 SEC Ann. Rep. 39 (1988) (discussing the EDGAR system). *See also* Securities Exchange Act Release No. 22446, (September 23, 1985), 50 FR 40479.

Several commenters noted that establishment of a central repository would obviate the need for the piggyback provision by making the required information instantly available through an electronic data base. A few commenters believed that a repository would promote equal access to information and would significantly reduce compliance costs. Supporters of a central repository offered a number of suggestions covering such matters as who should establish the repository; who should be required to file the data; whether to indicate that the issuer is current in filing its required reports; and how to finance such a system.

II. Discussion

The Commission has carefully reviewed the submissions received in response to the 1989 Release and has determined to propose amendments to Rule 15c2–11 that would modify substantially or, alternatively, repeal the piggyback exception. At the same time, the Commission believes that the establishment of a central repository of issuer and related information that the Rule requires broker-dealers individually to gather and maintain should be encouraged.

A. Reasons for the Proposals

It appears to the Commission that the underlying assumption of the piggyback exception, *i.e.*, that regular and frequent quotations for a security generally reflect supply and demand forces based on independent, informed pricing decisions, may not be valid in the context of the present-day coverage of the Rule, which is now primarily limited to the non-NASDAQ market. As observed by the Commission in the 1989 Release, and as confirmed by the NASD's similar regulatory experience,[44] the markets for non-NASDAQ securities, in general, do not now conform to that underlying assumption. Investigations involving those securities in the past few years, for example, demonstrate that low-priced, relatively unknown, speculative stocks predominate in those markets, and that the markets are frequently characterized by a prevalence of name-only quotations and an absence of market making, as well as retail, competition.[45] Since those markets seldom display the kind of supply/demand influences assumed by the present piggyback exception, the rationale for the provision is open to serious question.

The Commission preliminarily believes, therefore, that corrective regulatory action is now needed to enhance the quality of pricing decisions and better position each broker or dealer initiating or resuming quotations to guard against becoming an unwitting participant in incipient or ongoing fraudulent and manipulative schemes with respect to the security. A desirable by-product of substantially narrowing the scope of the piggyback exception, or eliminating it, would be a regular flow of significant and current information into the marketplace, thus increasing the quality of decisionmaking, including pricing determinations, of all market participants. In the Commission's experience, the kinds of fraud and manipulation at which the Rule is aimed are far more difficult to carry out in an informed market environment.

[44] Letter from NASD to Jonathan G. Katz, Secretary, SEC, pp. 6–7, dated February 15, 1990, included in File No. S7–27–89.

[45] See, *e.g.*, *SEC* v. *Brownstone-Smith Securities Corp., No.* 89–6249–CIV–GONZALEZ (S.D. Fla. permanent injunction entered May 25, 1989), *summarized in* Litigation Release No. 12126 (June 12, 1989), 43 SEC Docket (CCH) 1748, and No. 12132 (June 16, 1989), 43 SEC Docket (CCH) 1841.

B. Modified "Self-Piggybacking" Proposal

In order to achieve the foregoing policy objectives, the Commission preliminarily is of the view that it is appropriate to require all market makers in a non-NASDAQ security, not only the firm whose quotations establish the piggyback exception in the first instance, to collect and review the Rule's required information whenever they initiate or resume their quotations. The Commission also preliminarily believes, however, that there is a substantial basis for providing somewhat different treatment for self-piggybacking. In this regard, a crucial distinction between self-piggybacking and piggybacking in general is that a self-piggybacking firm will have collected and reviewed the information required by the Rule prior to initiating or resuming its quotations, whereas a broker-dealer piggybacking on another broker-dealer's quotations may never have reviewed information about the security or its issuer.

Moreover, total repeal of piggybacking (including self-piggybacking) might impose substantial costs by placing on every market maker publishing quotes for a non-NASDAQ security the responsibility to gather, review, and maintain, on a current basis and throughout the time that it publishes quotations for the security, the documents concerning that security and the issuer called for by the Rule. Accordingly, the Commission believes that it would be consistent with the

purposes of the Rule to retain a modified version of the piggyback exception for a firm that has satisfied the information gathering and review requirements upon its initiation of quotations and thereafter regularly publishes quotations for the security. Specifically, under the proposed approach, every broker-dealer, on initiating or resuming its quotations for a non-NASDAQ security, would have to gather and review the required information concerning the issuer, and then publish quotations satisfying the current 30-day quotation frequency requirements.[46] The broker-dealer thereafter would be able to publish quotations without gathering additional information ("self-piggyback") until the occurrence of the earlier of (1) a hiatus of four consecutive business days in publication of the firm's quotations for the security, (2) a failure by the firm to meet the minimum quotation frequency criterion of 12 business days per 30-calendar-day period, or (3) the yearly anniversary of the date of initiation of quotations in the security by the firm. At that point, the firm would be required to obtain and review the then current required information prior to resuming or continuing quotations. In this way, there would be some assurance that reasonably current information relating to non-NASDAQ issuers would continue to be available to, and reviewed by, market makers and others to help prevent fraud and to facilitate pricing decisions. The Commission preliminarily believes that an annual informational gathering and review requirement fulfills the objectives of the Rule without imposing significant burdens on market makers. The Commission solicits comment on the costs and benefits of this updating requirement, and whether other alternatives would be equally effective. Also, the Commission solicits comment on whether, in the context of its consideration of changes in the piggyback provision, the Commission should distinguish between wholesale and retail firms.[47] Finally, the Commission seeks comment on whether total repeal of the provision would be preferable to the modified self-piggybacking proposal.

C. Costs and Benefits

The Commission has taken into account the fact that, if the piggyback exception were narrowed or eliminated as proposed herein, the recordkeeping burdens and costs of some firms would be increased. As has previously been noted, however, the Commission is aware that many broker-dealers routinely assemble and maintain the specified information, despite the availability of the piggyback exception, for example, in order to fulfill their retail obligations to public customers or to simplify their compliance with the Rule.[48] Moreover, in view of the expected benefits of the proposed amendments, discussed above, the Commission believes that, on balance, any additional costs associated with curtailment of the exception would be justified.[49]

In reaching this preliminary conclusion, the Commission has considered the following factors. First, the Commission understands that market makers often are included on an issuer's mailing list or subscribe to a recognized document retrieval service and regularly receive documents publicly disseminated by the issuer. If an exception (e.g., a piggyback exception) were not available, a broker-dealer who, by such means, has received an issuer's reports or other required information on a timely basis for a period of time, may reasonably assume that it has satisfied the requirements of the Rule unless the broker-dealer has contrary information, e.g., that the issuer has failed to file a required report or has filed a report that has not been sent to the broker-dealer.[50]

Second, as already noted,[51] when paragraph (a)(3) information for a reporting issuer is not reasonably available, *e.g.*, because the issuer is delinquent in its filing obligations, the broker-dealer may substitute the information specified by paragraph (a)(5) in order to publish or submit quotations.[52] Broker-dealers usually should encounter little difficulty or costs in complying with their more limited obligations under paragraph (a)(5). In general, a broker-dealer that cannot piggyback or self-piggyback need only update its information files concerning paragraph (a)(5) issuers about once a year unless, of course, it has knowledge of intervening circumstances (*e.g.*, a trading suspension or other "red flags") that would call for earlier inquiry on its part.[53] If "reasonably current" paragraph (a)(5) information is unavailable, however, the broker-dealer may not publish or submit a quotation, unless an exception to, or an exemption from, the Rule is applicable.[54]

D. Bankruptcy Situations

In the 1989 Release,[55] the Commission inquired specifically whether there were situations, such as where the issuer was in bankruptcy, that should be addressed in the Rule if self-piggybacking were eliminated. Many commenters focused on this issue as it related to debtor companies and other issuers as to which current information was not available for purposes of satisfying the Rule's requirements. These commenters urged that it was in the public interest to permit continuation of all quotations for securities of these issuers; however, all favored a requirement that the absence of such information be highlighted appropriately in the quotation medium by a designation, such as the symbol "VJ" traditionally utilized in the pink sheets for issuers in bankruptcy.

The Commission is of the view that to permit the initiation or indefinite continuation of quotations where not even the basic information provided for by paragraph (a)(5) of the Rule is

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[46] See *supra* text accompanying nn. 28–33.

[47] See Release 34–29094 at text accompanying nn. 20–22 and 37–39.

[48] See supra n. 33 and text accompanying nn. 38–40.

[49] In considering the anticipated compliance costs resulting from the proposed amendments, it should be borne in mind that there may be some partially offsetting reductions of such burdens. As suggested in the 1989 Release, 54 FR at 39203, there are now certain costs incurred by broker-dealers in monitoring their compliance with the piggyback provision. These costs would be reduced significantly if the modified self-piggybacking proposal were adopted and would no longer exist if the total repeal alternative were adopted. Other monitoring costs might also be reduced or avoided. See supra n. 40.

[50] See Release 34–29094.

[51] *Supra* n. 25.

[52] See Release 34–21470, 49 FR at 45117. The Commission observes that the fact that an issuer is known to be delinquent in its filing obligations is a fact concerning the issuer that must be recorded pursuant to paragraph (b), and considered in reviewing other Rule 15c2–11 information and satisfying the "reasonable basis" requirement of paragraph (a).

[53] See paragraph (g) of the Rule. Under this provision, paragraph (a)(5) issuer information is presumed to be "reasonably current" if: "(1) The balance sheet is as of a date less than 16 months before the publication or submission of the quotation, the statements of profit and loss and retained earnings are for the 12 months preceding the date of such balance sheet, and if such balance sheet is not as of a date less than 6 months before the publication or submission of the quotation, it shall be accompanied by additional statements of profit and loss and retained earnings for the period from the date of such balance sheet to a date less than 6 months before the publication or submission of the quotation. (2) Other information regarding the issuer specified in paragraph (a)(5) of this section is as of a date within 12 months prior to the publication or submission of the quotation."

See also Release 34–29094 (discussing the review obligations of brokers and dealers under the Rule).

Additionally, it should be noted that under the modified self-piggybacking proposal, a qualifying broker-dealer's updating responsibilities with respect to reporting and non-reporting issuers would be substantially parallel.

[54] See paragraphs (f) and (h) of the Rule and *supra* n. 15.

[55] 54 FR at 39203.

available to the marketplace would directly undercut the prophylactic design of the Rule and might in fact encourage the abuses sought to be prevented. Moreover, even assuming that a workable system could be developed for identifying issuers that are delinquent in meeting their reporting obligations or have failed to publish "reasonably current" paragraph (a)(5) information, a general exception to the Rule along the lines suggested would remove a significant incentive for these issuers to provide information to their current and prospective security holders, and market participants generally. Nonetheless, in individual cases where it can be established that, for example, because of the issuer's depleted financial condition and limitations necessarily imposed in a pending bankruptcy proceeding, it is not practicable to generate all of the requisite information, the Commission would be prepared to consider granting exemptions under paragraph (h) of the Rule. In evaluating an exemption request, however, the Commission would generally consider the procedures that had been, and would be, used to disclose to the marketplace the extraordinary nature of the circumstances relating to the particular issuer, and the efforts that the issuer had made to fulfill applicable Exchange Act reporting obligations.[56]

E. Central Information Repository

The possible net addition of recordkeeping costs as a result of narrowing or eliminating the piggyback exception further highlights the desirability of creating a central database for information on non-NASDAQ issuers and their securities. In that regard, the Commission strongly supports the development of one or more central repositories for Rule 15c2–11 information. The use of such repositories may provide a more efficient vehicle for meeting the information gathering needs of brokers and dealers, including firms seeking to comply not only with Rule 15c2–11, but also with other applicable requirements.[57] The repositories can also substantially increase the availability of information on non-NASDAQ issuers to investors, other professionals, and interested regulators.[58]

In light of the potential benefits of the Rule 15c2–11 information repository concept and the NASD's recommendation that initiatives for the development of repositories be left to private commercial interests, the Commission has preliminarily determined to encourage such initiatives. In this connection, the Commission believes that the existence of a repository containing the elementary features discussed in or implied by the prior industry comments might justify an exception from Rule 15c2–11's recordkeeping provisions with respect to the documents available to the subject broker-dealer through a recognized repository.[59] Accordingly, the Commission is proposing for comment an amendment to the Rule that would accomplish that result.[60] While the proposal contemplates a reduction of record gathering and maintenance burdens for individual firms, it would not affect a broker-dealer's obligation under the Rule reasonably to review and satisfy itself as to the sources and accuracy of the specified information.

In addition, the Commission requests comments on what further steps for reducing or eliminating current regulatory requirements might be considered if a repository is implemented.

F. Identification of Unsolicited Customer Indications of Interest

The proposed modification or deletion of the piggyback exception raises a further issue which commenters are requested to address. At the present time, both the pink sheets and the NASD's OTC Service provide for the identification of quotations that represent unsolicited customer indications of interest.[61] A major reason why these quotation mediums have adopted this practice appears to be that, under paragraph (f)(3) of the Rule, participating brokers and dealers can take advantage of the piggyback exception under conditions that are less restrictive than would be available if such customer interests were not identified.[62]

Paragraph (f)(3)(i) permits broker-dealers to piggyback in an interdealer quotation system that specifically identifies unsolicited customer indications of interest if the security has been the subject of *any* form of quotations (exclusive of any identified customer interests) with the frequency and for the duration required by the Rule. Paragraph (f)(3)(ii), however, provides that in order to piggyback in an interdealer quotation system that does not identify unsolicited customer indications of interest, the security must have been "the subject of *both* bid and ask quotations * * * at *specified prices*" with the requisite frequency and duration in the system (emphasis added).

The current, more restrictive piggyback conditions applicable to quotations systems that do not identify those interests are founded on two factors. First, a quotation reflecting an unsolicited customer's interest in buying or selling a particular OTC security normally is a much weaker indicator of the security's market activity and liquidity ("quality of market") than other quotations, particularly quotations reflecting a market maker's proprietary interest. Second, firms entering solely unsolicited customer interests generally are not subject to the information gathering and review requirements of the Rule.[63] This can further weaken the quotation's quality-of-market value. Thus, the present Rule reflects the Commission's view that, in the absence of disclosure in the interdealer quotation system as to the source of the quotation, the quality of market needed to qualify the security for the piggyback exception should be set at a higher level.[64]

[56] *Cf. SEC Staff No-action Letter Regarding MMR Holding Corporation* (December 6, 1990).

[57] See, *e.g.*, *supra* n.33.

[58] See *supra* nn.42–43.

[59] Cf. Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 (adopting Rule 15c2–12, 17 CFR 240.15c2–12). As indicated in some of the responses to the 1989 Release, the potential benefits of such information systems correspond in many ways to those projected for the Commission's EDGAR system. While the Commission believes that, because of the similarity of concepts and objectives, these systems may someday be linked, it does not believe that the development of Rule 15c2–11 repositories need await full EDGAR implementation or the formulation of plans and policies for such linkages, as recommended by the NASD. See *supra* n. 42.

[60] See proposed paragraph (a) of the Rule, *infra*. In determining whether to designate a particular entity as a securities information repository, the Commission would consider, among other things, whether the repository: (1) collects information about a substantial segment of non-NASDAQ issuers; (2) maintains current, accurate information about the issuers of non-NASDAQ securities; (3) has effective acquisition, retrieval, and dissemination systems; (4) places no inappropriate limits on the issuers from or about which it will accept information; (5) provides access to the documents deposited with it to anyone willing and able to pay the applicable fees; and (6) charges reasonable fees.

[61] Both systems use the designation "UNS" to identify each quotation reflecting an unsolicited customer indication of interest. See Release 34–27975–A, 55 FR at 23161.

[62] See Release 34–21470, 49 FR at 45121.

[63] See *supra* n.13. In contrast, on NASDAQ, an interdealer quotation system that is excepted from the Rule, see paragraph (f)(5), the published quotations must reflect prices at which the firm is willing to transact business for its own account. See NASD By-laws, Schedule D, NASD Manual (CCH), ¶1819.

[64] The current exclusion of the identified quotes from the formula for determining whether the more

Continued

With the modification or elimination of present paragraph (f)(3), as proposed, this purpose for identification, and the distinction between quotation mediums based upon such identification, would be removed. A question then arises as to whether the Commission should mandate the continuation of the practice, *i.e.*, by requiring broker-dealers to identify their quotations in an interdealer quotation system that represent unsolicited customer indications of interest. Because such identification provides market participants with valuable information concerning the quality of market for a non-NASDAQ security, the Commission preliminarily believes that the practice should continue notwithstanding the modification of the piggyback provision. Accordingly, the Commission proposes to amend the Rule to require identification of quotations representing unsolicited customer indications of interest.[65]

C. The Furnishing of Issuer Information to Interdealer Quotation Systems under Paragraph (d)

Under paragraph (d) of the Rule, a broker-dealer wishing to submit a quotation for publication in an interdealer quotation system pursuant to paragraph (a)(5) is required to furnish to the system in advance the information described in paragraph (a)(5). This requirement was included in the Rule to facilitate the cooperative surveillance efforts of the system with those of the Commission staff with respect to the markets for securities of paragraph (a)(5) (*i.e.*, non-reporting) issuers. Until recently, the National Quotation Bureau (publisher of the pink sheets), which is a private commercial enterprise, was the principal quotation medium for such securities.[66] As noted above, however, the NASD, which is both a registered self-regulatory organization and the sponsor of an interdealer quotation system (the OTC Service), has recently undertaken a primary surveillance role for the non-NASDAQ markets and, with Commission encouragement, has adopted a variety of rules and supervisory procedures for that purpose.[67] Among other things, NASD members desiring to publish quotations in the OTC Service or another interdealer quotation system must demonstrate compliance with Rule 15c2–11 by furnishing to the NASD, when applicable, the required paragraph (a)(5) information.

While the Commission believes that the requirements of paragraph (d) facilitate surveillance of activity in the non-NASDAQ market, it may be appropriate to eliminate paragraph (d) from the Rule if the piggyback exception is narrowed or repealed. For example, if the exception were repealed and paragraph (d) retained, substantial modifications of the provisions of paragraph (d) would be needed to avoid duplication in the furnishing of materials under that paragraph and related NASD rules. Accordingly, the Commission proposes to remove paragraph (d) from the Rule and thus give the NASD, subject to Commission oversight, greater leeway to determine how best to meet its surveillance objectives, avoid unnecessary duplication of filing burdens, and cooperate with private interdealer quotation systems.[68]

III. Solicitation of Comment

All interested persons are invited to submit written data, views, and arguments concerning the foregoing. The Commission notes that the proposed amendments to Rule 15c2–11 discussed above present questions as to the potential costs and benefits of their adoption. Commenters are therefore urged specifically to address those questions and to quantify their responses where possible.

To a significant extent, cost/benefit issues related to the proposed piggyback and repository amendments have been explored by the Commission on prior occasions.[69] In those instances, however, commenters, including market makers, did not have any actual experience with the operation of the amendments to the Rule incorporated in today's companion release concerning broker-dealers' record assembly and review responsibilities. Since the modification or elimination of the piggyback exception likely would result in an increase in the frequency with which broker-dealers would be required to comply with those responsibilities, the Commission would prefer that firms acquire such experience, over a period of several months, before presenting their views on the new proposals. Under the circumstances, the Commission is providing for the comment period to end January 1, 1992. The Commission specifically invites comment regarding any aspects of Rule 15c2–11, as amended in Release 34–29094, that would be insufficient, burdensome, or unnecessary if the amendments are adopted substantially as proposed or if the piggyback provisions were repealed completely.

The Commission also seeks comment on whether there are alternative regulatory approaches that would provide equivalent (or greater) benefits at lower costs to broker-dealers, issuers, quotation media, interested regulators, or public investors. The costs and benefits of any such alternatives should be explained and quantified to the extent feasible.

Persons desiring to make written submissions should submit three copies thereof to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549, no later than January 1, 1992, and refer to file No. S7–9–91.

IV. Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA") in accordance with 5 U.S.C. 603 regarding the proposed amendments to Rule 15c2–11. The IRFA notes that the current piggyback provision can result in market makers unintentionally facilitating fraudulent schemes in that their introduction of quotations can add credibility to the illusion of a legitimate market for the securities involved. The IRFA states that narrowing or eliminating the piggyback exception, and extending the Rule's information gathering and review requirements to all participating market makers initiating or resuming quotations, would further the efficient valuation of non-NASDAQ securities and increase the likelihood that fraudulent schemes would be quickly exposed. The IRFA suggests, as an alternative to complete repeal of the piggyback exception, an approach that would permit broker-dealers who regularly quote non-NASDAQ securities to self-piggyback for one or more one-year periods. The Commission specifically seeks comments on any additional burdens on, or costs, to small broker-dealers and issuers associated with the elimination or significant modification of the piggyback exception.

In addition, the Commission seeks comment on the extent to which the proposed amendment encouraging the development of a central repository would reduce recordkeeping and other compliance costs. The IRFA notes that

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liberal piggyback criteria are satisfied is based on similar considerations. See paragraph (f)(3)(i) of the Rule.

[65] See paragraph (f)(2) of the Rule, as proposed to be amended, *infra*.

[66] The Bureau's surveillance role is summarized in Release 34–21914, 50 FR at 14112.

[67] See, *e.g.*, *supra* n.40.

[68] The Commission requests comment on whether it is necessary or appropriate to retain paragraph (d), in light of the NASD's initiatives regarding non-NASDAQ surveillance, even if the piggyback exception is retained in some form.

[69] See, *e.g.*, the 1989 Release and Release 34–21914.

the possible imposition of additional recordkeeping costs resulting from the proposed changes in the piggyback exception increases the desirability of creating a central database for information on non-NASDAQ issuers and their securities.

The IRFA notes that an additional amendment to the Rule, requiring broker-dealers to identify quotations which represent unsolicited customer indications of interest, continues the general industry practice and places no significant additional burden on small broker-dealers. It is also noted that eliminating the requirement to furnish certain information to an interdealer quotation system prior to publication of a quotation, should reduce recordkeeping and compliance costs for all broker-dealers since it would give the NASD greater flexibility to lessen the incidence of duplication in the furnishing of the information to interdealer quotation systems.

A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting Jodie J. Kelley, Division of Market Regulation, Securities and Exchange Commission, Washington, DC 20549, (202) 272–2848.

V. Effects on Competition

Section 23(a)(2) of the Exchange Act [70] requires the Commission, in adopting rules under the Exchange Act, to consider any anticompetitive effects of such rules and to balance these effects against the regulatory benefits gained in furthering the purposes of the Exchange Act. The Commission views, preliminarily, the proposed amendments to Rule 15c2–11 as causing no burden on competition unnecessary or inappropriate in furtherance of the purposes of the Exchange Act. The Commission, however, requests comment on any competitive burdens that might result from adoption of the proposed amendments described in this release.

VI. Statutory Basis

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

Reporting and recordkeeping requirements, Securities.

VII. Text of Proposed Rule Amendments

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

[70] 15 U.S.C. 78w(a)(2).

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

1. The authority citation for Part 240 is amended by adding the following citation:

Authority: 15 U.S.C. 77c, 77d, 77s, 78c, 78d, 78i, 78j, 78l, 78m, 78n, 78o, 78p, 78s, 78w, 78x, 79q, 79t, 80a–29, 80a–37, unless otherwise noted.

* * * * *

Section 240.15c2–11 also issued under 15 U.S.C. 78j(b), 78o(c), 78o(g), 78q(a), and 78w(a).

2. Section 240.15c2–11 is amended by redesignating paragraph (c) as (c)(1), adding paragraph (c)(2), removing paragraph (d), redesignating paragraphs (e) through (h) as (d) through (g), and revising newly designated paragraphs (e)(2) and (e)(3) to read as follows:

Note: Arrows indicate text proposed to be added. Brackets indicate text proposed to be removed.

§ 240.15c2–11 Initiation or resumption of quotations without specified information.

* * * * *

(c)>(1)< * * *

>(2) The broker or dealer need not have in its records the information described in this paragraph (a), or make information available to other persons in accordance with paragraph (a)(4) or (a)(5) of this section, to the extent that such information is reasonably available to the broker or dealer and such other persons from an entity designated by the Commission by rule, regulation, or order as a securities information repository. In determining whether to grant, deny, suspend, condition, or withdraw such a designation, the Commission will consider whether the repository:

(i) Collects information about a substantial segment of issuers of securities subject to this rule;

(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 reasonably to carry out the purposes of this section. <

* * * * *

(e) * * *

(2) The publication or submission by a broker or dealer, solely on behalf of a customer (other than a person acting as or for a dealer), of a quotation that represents the customer's indication of interest and does not involve the solicitation of the customer's interest; *Provided, however,* That [this paragraph (f)(2) shall not apply to a quotation consisting of both a bid and an offer, each of which is at a specified price, unless the quotation medium specifically identifies the quotation as representing such an unsolicited customer interest.] > no broker or dealer shall publish or submit for publication in an interdealer quotation system a quotation representing such an unsolicited customer interest unless the system specifically so identifies the quotation. <

(3)> The publication or submission by a broker or dealer, in an interdealer quotation system, of a quotation respecting a security which has been the subject of quotations by that broker or dealer in such a system on each of at least 12 days within the previous 30 calendar days and no more than 4 successive business days have elapsed during such 30-day period between published quotations of such broker or dealer for the security: *Provided,* That such broker or dealer has, at least once during the 12-month period prior to the publication or submission of the quotation, complied with the provisions of paragraph (a) of this section concerning the requirement to have and review specified records relating to the security. <

* * * * *

By the Commission.

Dated: April 17, 1991.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 91–9416 Filed 4–24–91; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 241

[Release No. 34–29093; File No. S7–8–91]

RIN: 3235–AE21

Penny Stock Disclosure Rules

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: The Commission is proposing for public comment Rule 3a51–1, Rules 15g–1 through 15g–7, and Schedule 15G to implement certain penny stock

provisions of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. These rules define the term "penny stock" and provide certain exemptions. They also require broker-dealers selling penny stocks to their customers to provide the customers with: A risk disclosure document; monthly statements giving the market value of penny stocks held for the customer; disclosure of market quotations, if any; disclosure of the compensation of the broker-dealer and the salesperson in the trade; and disclosure when the broker-dealer is acting as sole market maker in the security.

DATES: Comments should be submitted by July 19, 1991.

ADDRESSES: Interested persons should submit three copies of their views to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth St. NW., Mail Stop 6-9, Washington, DC 20549, and should refer to File No. S7-8-91. All submissions will be available for public inspection at the Commission's Public Reference Branch, 450 Fifth St. NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Robert L.D. Colby, Chief Counsel; or Belinda Blaine, Attorney, (with respect to Rules 3a51-1 and 15g-1); Marie D'Aguanno Ito, Attorney, (with respect to Rules 15g-2 and 15g-3 and Schedule 15G); Alexander Dill, Attorney, (with respect to Rule 15g-4); or John Ramsay, Attorney, (with respect to Rules 15g-5, 15g-6, and 15g-7); all at 202-272-2844, Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth St. NW., Mail Stop 5-1, Washington DC 20549.

SUPPLEMENTARY INFORMATION:

Table of Contents

I. Executive Summary
II. Introduction
A. Origins and Nature of Penny Stock Fraud
B. Regulatory Environment and Changes
III. Rules
A. General
B. Rule 3a51-1: Definition of Penny Stock
1. Reported Securities
2. Price of the Security
3. Qualification Standards
C. Rule 15g-1: Exemptions from Proposed Rules
1. Limited Broker-Dealer Activity in Penny Stocks
2. Net Tangible Assets
3. Institutional Accredited Investors
4. Non-Recommended Transactions
5. Issuer Repurchases
6. Exchange-Listed and NASDAQ Securities
7. Exemptive Authority
8 Rule 15g-7
9. Request for Comment
D. Rule 15g-2: Penny Stock Risk Disclosure Document
1. Background
2. Request for Comment
E. Rule 15g-3: Broker-Dealer Disclosure of Quotations and Other Information Relating to the Penny Stock Market
1. Background
2. Summary of Proposed Rule 15g-3
3. Request for Comment
F. Rule 15g-4: Compensation of Brokers or Dealers
1. Introduction
2. Definition of Compensation
3. Request for Comment
G. Rule 15g-5: Associated Person Compensation
1. Compensation of Salespersons in the Penny Stock Market
2. Description of the Proposed Rule
3. Request for Comment
H. Disclosure Procedures for Rules 15g-3, 15g-4, and 15g-5
I. Rule 15g-6: Monthly Account Statements
1. General Description of Proposed Rule
2. Objectives of the Proposed Rule
3. Information to be Contained in Account Statements
i. Identifying Information
ii. Market Value
4. Prescribed Legend
5. Recordkeeping
6. Request for Comment
J. Rule 15g-7: Penny Stock Market Makers
1. Description of the Proposed Rule
2. Disclosure of Sole Market Maker Status
3. Prohibited Representations
4. Request for Comment
IV. Rule 15c2-6
V. Conclusion
VI. Effects on Competition and Regulatory Flexibility Act Considerations
VII. Statutory Basis and Text of Amendments

I. Executive Summary

The Commission is proposing for public comment Rule 3a51-1 and Rules 15g-1 through 15g-7 under the Securities Exchange Act of 1934 ("Exchange Act") to implement certain provisions of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("Penny Stock Act"). The Penny Stock Act amends the Exchange Act by adding a new section 3(a)(51), which provides a general definition of "penny stock," subject to further definition by Commission rule, and section 15(g), which directs the Commission to adopt specific rules concerning broker-dealer disclosures to customers.

Rule 3a51-1—Definition of "Penny Stock"

Pursuant to section 3(a)(51) of the Exchange Act, proposed Rule 3a51-1 would further define the term "penny stock" to exclude certain additional types of equity securities. Proposed Rule 3a51-1 would exclude from the definition of penny stock securities that are "reported securities," *i.e.*, securities for which last sale reports are collected and made available pursuant to an effective transaction reporting plan. Generally, reported securities consist of New York Stock Exchange, Inc. ("NYSE"), American Stock Exchange, Inc. ("Amex"), and certain regional exchange-listed securities that meet NYSE or Amex listing standards. Reported securities also include securities quoted on the National Association of Securities Dealers, Inc.'s ("NASD") NASDAQ system that are designated as National Market System securities ("NASDAQ/NMS securities").

Proposed Rule 3a51-1 also would exclude from the definition of penny stock securities that have a price of five dollars or more (including any share of any unit that has an independent exercise price), as determined (a) on a per transaction basis or (b) on the basis of an exchange quotation or at least three *bona fide* interdealer bid quotations on an interdealer quotation system.

The proposed rule would further exclude from the definition of penny stock securities (i) issued by an investment company registered under the Investment Company Act of 1940, and (ii) that are put or call options issued by the Options Clearing Corporation.

Finally, proposed Rule 3a51-1 would exclude securities registered or approved for registration on a national securities exchange that has maintenance criteria authorizing, at a minimum, the delisting of a security whose issuer has less than $2,000,000 in net tangible assets or in stockholder equity.[1] This provision currently would exclude equity securities listed on the NYSE, the Amex, and the Chicago Board Options Exchange, Inc. ("CBOE"). Because the standards for being deemed a "reported security" are based on NYSE and Amex listing standards, this provision would not currently exclude any listed securities that are not already covered by the exclusions for reported securities or options issued by the Options Clearing Corporation. It would, however, allow an exchange to qualify for exclusion of its securities by raising its maintenance standards to the $2,000,000 level.

Proposed Rule 3a51-1 would establish similar maintenance criteria as the basis

[1] This provision implements the requirement in the Penny Stock Act that the Commission specify criteria for the exclusion from the definition of penny stock of equity securities listed on an exchange.

for excluding from the penny stock definition securities quoted or authorized for quotation on an automated quotation system. Because at this time the NASDAQ system does not satisfy these criteria, NASDAQ securities as a whole would not be excluded from the definition of penny stock. NASDAQ/NMS securities would be separately excluded from this definition.

Rule 15g–1—Exemptions

Pursuant to section 15(g)(4) of the Act, proposed Rule 15g–1 would exempt certain transactions from all of the proposed penny stock rules that require broker-dealer disclosures to customers, with the exception of proposed Rule 15g–7, which requires disclosure of sole market maker status. First, proposed Rule 15g–1 would exempt from proposed Rules 15g–2 through 15g–6 transactions in penny stocks by a broker-dealer that does less than five percent of its securities business in penny stocks and that has not been a market maker, during the past year, in the penny stock that is the subject of the transaction. Second, proposed Rule 15g–1 would exempt transactions in securities the issuer of which has net tangible assets in excess of $2,000,000, if that issuer has been in continuous operation for at least three years, or $5,000,000, if the issuer has been in continuous operation for less than three years. The net tangible assets standard must be demonstrated by current, audited financial statements that the broker-dealer has reviewed and has a reasonable basis for believing are accurate. Third, proposed Rule 15g–1 would exempt transactions in securities if the customer is an institutional accredited investor. Fourth, the proposed rule would exempt transactions that are not recommended by the broker-dealer. Finally, the proposed rule would exempt transactions in which the purchaser is the issuer of the penny stock that is the subject of the transaction.

Proposed Rule 15g–1 also would exempt specific transactions in penny stocks from proposed Rule 15g–2, which requires provision of a risk disclosure document, proposed Rule 15g–3, which requires disclosure of bid and ask prices, and proposed Rule 15g–6, which requires provision of monthly account statements. Rule 15g–1 would exempt from these proposed Rules transactions in securities:

(1) Registered or approved for registration, and executed on, a national securities exchange that makes transaction reports available pursuant to an effective transaction reporting plan; or

(2) Authorized, or approved for authorization, for quotation in the NASDAQ system, where the transaction is executed with or by a dealer registered as a NASDAQ market maker in the penny stock, a broker crossing two customer orders on an agency basis, or an underwriter or any syndicate or selling group member that is participating in a distribution of the penny stock that is the subject of the transaction.

Rule 15g–2—Risk Disclosure Document

Pursuant to section 15(g)(2) of the Exchange Act, proposed Rule 15g–2 would make it unlawful for a broker-dealer to effect transactions in penny stocks without first providing to the customer a standardized disclosure document as contained in proposed Schedule 15G. The document required by the proposed rule explains the risks of investing in penny stocks; important concepts associated with the penny stock market, such as the meaning of the "bid" and "ask" prices and the significance of the spread between those prices; the broker-dealer's duties to the customers, including disclosures required by each of the proposed rules; a toll-free telephone number through which a customer may inquire about the disciplinary history of a broker-dealer; the customer's rights and remedies in cases of fraud or abuse in connection with transactions in penny stocks; and other significant information of which the investor should be aware.

Rule 15g–3—Bid-Offer Quotations

Pursuant to section 15(g)(3)(A) (i) and (ii), proposed Rule 15g–3 would make it unlawful for a broker-dealer to effect a transaction in any penny stock without first disclosing and subsequently confirming to the customer current quotation prices or similar market information. For transactions effected on a principal basis, the broker-dealer must disclose its own bid and offer prices to a customer if the broker-dealer consistently has executed trades with other dealers at its quotations for the security over the past five business days, and if the broker-dealer believes that its present quotations accurately reflect the prices at which it is prepared to trade with other dealers. Otherwise, the dealer must disclose that it has not traded consistently at its quotes, and it must disclose the price at which it last purchased the penny stock from, or sold the penny stock to, another dealer in a *bona fide* transaction.

For transactions effected on an agency or riskless principal basis, the broker-dealer must disclose the best interdealer bid and offer prices for the penny stock that the broker-dealer obtains through reasonable diligence. For all such transactions in penny stocks, the broker-dealer must also disclose the number of shares to which the bid and offer prices apply.

Rule 15g–4—Broker-dealer Compensation

Pursuant to section 15(g)(3)(A)(iii) of the Exchange Act, proposed Rule 15g–4 would make it unlawful for a broker-dealer to effect a penny stock transaction for a customer unless the broker-dealer first discloses to the customer the amount of any compensation received in connection with that penny stock transaction. "Compensation" is defined in the proposed rule as:

(1) In the case of an agency transaction, the amount of any remuneration received or to be received from a customer in connection with the transaction;

(2) In the case of a "riskless principal" transaction, the difference between the price to the customer and the contemporaneous purchase or sale price; and

(3) Otherwise in the case of a principal transaction, the difference between the price to the customer and the prevailing market price in the security. This release contains a detailed discussion of the criteria to be used for determining "prevailing market price."

Rule 15g–5—Associated Person Compensation

Pursuant to section 15(g)(3)(A)(iii) of the Exchange Act, proposed Rule 15g–5 would make it unlawful for a broker-dealer to effect a transaction in any penny stock for a customer unless the broker-dealer first discloses and subsequently confirms to the customer:

(1) The aggregate or per share amount of cash compensation that the associated person of the broker-dealer has received or will receive from any source in connection with the transaction, in cases where the firm determines compensation on a transactional or per share basis; and

(2) The amount of cash or other compensation that the associated person has received from any source during the preceding calendar year in connection with all penny stock transactions, if this amount exceeds 25% of the total compensation that the associated person received during that year in connection with all securities transactions.

Rule 15g–6—Monthly Account Statements

Pursuant to section 15(g)(3)(B) of the Exchange Act, proposed Rule 15g–6 would make it unlawful for a broker-dealer that has effected a penny stock sale to a customer to fail to provide to that customer a monthly statement disclosing the identity and number of shares of each penny stock in the customer's account; the transaction dates; the purchase price; and the estimated market value of the security, based on the broker-dealer's recent purchase prices or recent dealer bids. The statement must also contain a standardized legend explaining the limited market for the securities and nature of an estimated market value in such a limited market. If the broker-dealer has not effected any penny stock transactions for the customer for six consecutive months, the rule would provide a limited exemption to permit account statements to be provided on a quarterly basis.

Rule 15g–7—Sole Market Makers

Pursuant to section 15(g)(5) of the Act, proposed Rule 15g–7 would make it unlawful for a broker-dealer that is the sole market maker in a penny stock, or an affiliated broker-dealer, to effect transactions in the stock unless the broker-dealer has disclosed to the customer that it or its affiliate is the sole market maker and that, by virtue of such status, it or its affiliate exercises substantial influence over the market for the security. Moreover, the proposed rule makes it unlawful for a broker-dealer that is a market maker in a penny stock or an affiliate to represent directly or indirectly to a customer that a transaction in the stock is being effected "at the market" or at a price related to the market unless the broker-dealer knows, or has reasonable grounds to believe, that a market exists outside of the broker-dealer's control.

II. Introduction

A. Origins and Nature of Penny Stock Fraud

The term "penny stock" generally refers to low-priced, speculative securities that are largely traded in the over-the-counter ("OTC") market.[2] The great majority of securities that are eligible for public trading in the United States are not traded on an established national securities exchange or the National Association of Securities Dealers Automated Quotation System ("NASDAQ").[3] Most of these non-NASDAQ, OTC securities are not actively traded in any forum, and frequently there is little public information available with respect to their issuers.

The historical origins of the penny stock market in the United States may be traced to a point as early as the 1880s, when speculation was fueled by gold mining expansion in Colorado. More recently, beginning in the 1950s and continuing until the early 1980s, substantial penny stock activity occurred periodically and was largely confined to parts of the western United States.[4] During this time span, periodic surges in penny stock sales typically were associated with "hot issues" activity occurring toward the end of advancing, or "bull," markets.[5]

Beginning in the mid-1980s, penny stock transactions and associated abuses grew geographically and in volume. Technological advances related to interstate telecommunications contributed substantially to this growth.[6] This period also witnessed a dramatic growth in the number of broker-dealers that concentrated their activities primarily or entirely in penny stock transactions.[7] In 1989, the Commission identified a corresponding increase in the number of investor complaints concerning these broker-dealers.[8] Government officials and commenters have stressed the threat posed by penny stock fraud to economic progress and the legitimate securities industry.[9] Penny stock fraud remains a serious national concern.[10]

In its report concerning the Penny Stock Reform Act of 1990,[11] the House Committee on Energy and Commerce (the "Committee") identified two primary factors spurring the growth of penny stock fraud: (i) A lack of public information concerning penny stocks, which facilitates price manipulation and deprives investors of a basis on which to make investment decisions, and (ii) the presence of a large number of individuals acting as promoters or associated with penny stock issuers or broker-dealers "who are repeat offenders of state or federal securities laws, other convicted felons, and persons having strong ties to organized crime." [12] With respect to recidivist

[2] For purposes of this section of this release, the term "penny stock" is used in this general sense. The Penny Stock Act added to the Exchange Act section 3(a)(51), which specifically defines the term "penny stock" and authorizes the Commission to designate or exempt certain classes of securities from the definition.

[3] The NASD stated in April 1990 that of the approximately 55,000 securities available for public trading, approximately 2,240 were listed on the New York Stock Exchange, 1,100 were listed on the American Stock Exchange, and 4,970 were listed on NASDAQ. *Penny Stock Fraud (Part 2): Hearing Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 101st Cong., 2d Sess., on H.R. 4497 (April 25, 1990) (the "1990 Hearing"), Statement of the NASD, at 136.

[4] House Comm. on Energy and Commerce, *Report to accompany the Penny Stock Reform Act of 1990*, H.R. Rep. No. 617, 101st Cong., 2d Sess. (July 23, 1990) (reporting H.R. 4497) (hereinafter "House Report"), at 9.

[5] *Fraud and Abuse in the "Hot Issues" and "Penny Stock" Markets: Hearing Before the Subcomm. on Securities of the House Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 1st Sess. (December 15, 1983) ("1983 Hearing"), 9–10, 12–13 (statement of John Shad, Chairman, Securities and Exchange Commission).

[6] House Report, at 9–10.

[7] See *The North American Securities Administrators Association Report on Fraud and Abuse in the Penny Stock Industry* (September 1989) (the "NASAA Report"), *reprinted in Penny Stock Market Fraud: Hearings Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 101st Cong., 1st Sess. (August 21 and September 7, 1989) ("1989 Hearings"), at 149–244.

[8] Securities Exchange Act Release No. 27160 (August 22, 1989), 54 FR 35469 (adopting 15c2–6 under the Exchange Act) ("Rule 15c2–6 Adoption Release"), n.9, at 35469.

[9] A 1985 article, in discussing penny stock fraud and other investment scams, stated that "[t]he U.S. is in the grip of the most devastating epidemic of investment swindles and near-swindles in its history." R. Stern and L. Gubernick, *The Smarter They Are, the Harder They Fall*, Forbes (May 20, 1985), at 38. Commission Chairman Richard C. Breeden has called it an "economic crime." Statement of the Hon. Richard C. Breeden, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, 35 (April 25, 1990) ("Statement of Chairman Breeden"). A former Chairman of the Commission stated that penny stock fraud was "one of the most menacing problems facing investors, regulators, and the legitimate securities industry." Statement of the Hon. David S. Ruder, Before the Subcommittee on Telecommunications and Finance of the U.S. House Committee on Energy and Commerce, 7–8 (April 19, 1989). The United States Attorney General has cited penny stock speculation as one of the factors that has "marred the landscape of economic progress." Address of the Hon. Richard Thornburgh at the Tennessee Law Review Banquet Celebrating the Centennial of the University of Tennessee College of Law (March 10, 1990), *reprinted in* 57 Tenn. L. Rev. 499, 503 (Winter 1990). See generally, the NASAA Report.

[10] Although there is some evidence of a recent decline in the number of penny stock broker-dealers, this occurrence may reflect only temporary economic conditions. House Report 18; 1990 Hearing 142 (statement of the NASD). Nationwide telemarketing schemes continue to arise. For a recent example, see "'Operation Desert Scams' Nab Investors," *Wall Street Journal* (February 14, 1991), p. C–1, col. 1.

[11] The provisions of the Penny Stock Act pertaining to penny stocks were introduced as the Penny Stock Reform Act of 1990, H.R. 4497.

[12] House Report at 10. Concerning ties between penny stock fraud and organized crime, see Testimony of Lorenzo Formato, Convicted Former Broker and Participant in the Federal Witness Protection Program, 1989 Hearings at 101–122.

offenders, the Committee noted the limited classes of persons that the Commission had authority to bar from association with broker-dealers.[13]

Many of the abusive practices identified in the penny stock market can be attributed to the communication by broker-dealers to their customers of false or misleading information as to the value or market price of securities in order to induce transactions in those securities. These practices are more likely to flourish where there is a paucity of price, quotation, and other market information concerning a security. Where such information is available to investors, they have a greater ability to judge the veracity of sales agent claims.[14] Most penny stocks are not actively traded in any secondary market, and dealer quotations, if they exist at all, traditionally have been confined to the "pink sheets." [15] Moreover, pink sheet quotations generally do not serve as a reliable indication of the price at which a public customer could effect a purchase or sale transaction.[16]

Certain patterns, although not exclusive, have been characteristic of penny stock fraud in recent years. These patterns include: (i) Control of the market for the security by one or a few broker-dealers that often are related to the promoter or issuer; (ii) manipulation of prices through pre-arranged matching of purchases and sales and false or misleading press releases; (iii) "boiler-room" practices involving high-pressure sales tactics and unrealistic price projections by inexperienced salespersons; (iv) excessive and undisclosed bid-ask spreads and mark-ups by selling broker-dealers; and (v) the wholesale "dumping" of the same securities by promoters and broker-dealers after prices have been manipulated to desired levels, along with the resulting inevitable collapse of those prices and investor losses.[17] Broker-dealers involved in these schemes contact potential investors primarily through the use of "cold calls," *i.e.*, high volume telephone calls to strangers based on general lists, such as telephone directories.[18]

The growth of penny stock offerings and secondary market transactions also often has been associated with "blank check" offerings, or offerings of securities of an issuer that, at the time of the offering, has no specific stated business plan or purpose. Because of the absence of significant business or financial information at the time of the offering, the use of a blank check format by penny stock issuers, in addition to the lack of market information concerning penny stocks generally, may further facilitate the use of fraudulent sales and trading practices.[19]

The large-scale and persistent pattern of abuse described above represents a continuing threat to individual investors in particular and to investor confidence generally. Moreover, issuers themselves may in some cases be deceived by promoters who make unfounded promises of easy and efficient access to new capital.[20]

B. Regulatory Environment and Changes

In response to the serious problems involving penny stocks, during the last several years the Commission, together with other federal departments and agencies, the NASD, and state agencies have expanded penny stock investigations and enforcement actions and have adopted regulatory changes. In October 1988, the Commission formed its Penny Stock Task Force (the "Task Force"), consisting of representatives of each of the Commission's operating divisions and regional offices. The Task Force identified as its primary goals (i) increasing coordination and sharing of information with other regulators and with prosecutors, (ii) increasing enforcement activities and criminal referrals, where appropriate, (iii) targeting regulatory changes, and (iv) improving investor education.[21]

Following the formation of the Task Force, the Commission substantially increased the level of enforcement actions involving penny stock issuers and broker-dealers.[22] Many of these enforcement efforts have involved large, national penny stock firms, the activities of which have affected thousands of investors.[23] The Commission also has substantially assisted in the prosecution of actions by other federal agencies, state authorities, and the NASD.[24] The Commission has acted to promote investor education through the publication of consumer brochures,[25] which have been disseminated by the Commission directly and by other parties, including state authorities and certain public utilities.

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[13] House Report at 21. On the presence of recidivist offenders generally, see House Report at 20–22.

[14] As the Commission observed in the 15c2–6 Adoption Release: "[M]any low-priced securities are issued by smaller, little-known companies that may attract little attention outside that generated by a boiler-room sales campaign. Often these issuers are not subject to Exchange Act reporting requirements. The scarcity of information about the issuer is further aggravated by the lack of information on transactions in the issuers' securities. 54 FR at 35470."

The Commission and public commenters have long recognized the value of increased disclosure to investors in the over-the-counter market. In the 1940s, the Commission proposed a rule requiring dealers in over-the-counter trades to disclose to customers on trade confirmations the best independent bid and offer available in the market at the time of the trade. See Securities Exchange Act Release No. 3940 (April 2, 1947). In 1963, the Special Study of Securities Markets ("Special Study") recommended requiring confirmation disclosure of the best interdealer bid or offer at the time of the transaction and the prevailing interdealer spread. The Special Study also recommended that, prior to effecting a transaction, dealers notify customers if no independent market existed in the security or if interdealer quotation spreads in the security exceeded 20 percent. *Report of the Special Study of Securities Markets of the SEC* (1963), *reprinted in* H.R. Doc. No. 95, 88th Cong., 1st Sess. Part 2, 677 (1963). Subsequently, Rule 10b–10 [17 CFR 240.10b–10], the Commission's confirmation rule, was amended to add some additional disclosures. These disclosures included, among other things, the market maker status of a broker-dealer executing a transaction as principal in an equity security, the amount of odd-lot differential fees charged, and the amount of the mark-up or mark-down in connection with a riskless principal transaction in an equity security. Securities Exchange Act Release No. 15219 (October 6, 1978), 43 FR 47495. See generally, Simon and Colby, *The National Market System for Over-the-Counter Stocks*, 55 Geo. Wash. L. Rev. 17, 19–34 (1986).

[15] The National Daily Quotation Service, also known as the "pink sheets," is published and distributed nationally by the National Quotation Bureau, Inc. ("NQB") and, with the exception of the NASD's new OTC Bulletin Board, is the principal interdealer quotation system for equity securities that are not listed on an exchange or quoted on the NASDAQ system. Other quotation media are distributed in limited geographical areas, e.g., the Regional Inter-Dealer Over-the-Counter Stock Quotations prepared by Metro Data Company in Minneapolis, Minnesota (also known as the "white sheets"). The "pink sheets" and these other quotation media generally carry quotations for securities with limited distribution and trading activity. Quotations in these media often consist only of the name of the broker-dealer that has entered the quotation.

[16] See 1989 Hearings at 127 (statement of John C. Baldwin, President, North American Securities Administrators Association).

[17] 1989 Hearings at 50–51 (statement of Joseph I. Goldstein, Associate Director, Division of Enforcement, Securities and Exchange Commission ("Statement of Joseph Goldstein")).

[18] See Rule 15c2–6 Adoption Release, 54 FR at 35469; Securities Exchange Act Release No. 26529 (February 8, 1989), 54 FR 6693, 6694 ("Rule 15c2–6 Proposal Release").

[19] See House Report at 22–23.

[20] See 1989 Hearings at 86–89 (statement of Curt B. Cleaves, Chairman, Oregon State Bar, Securities Regulation Section).

[21] See Statement of Joseph Goldstein, 1989 Hearings at 51; House Report 16–17.

[22] See Statement of Chairman Breeden, 1990 Hearing at 31, 34.

[23] These firms include Blinder, Robinson & Co., Inc., Stuart-James & Co., F.D. Roberts Securities, Inc., Onnix Financial Group, Inc., and Thomas James Associates, Inc., among others. See House Report 13–16.

[24] Statement of Joseph Goldstein, at 51–55.

[25] U.S. Securities and Exchange Commission, *The New Penny Stock Cold Calling Rule, Information for Investors* (Dec. 1989); *Penny Stock Telephone Fraud, Information for Investors* (June 1989); and *Beware of Penny Stock Fraud! Information for Investors (Nov. 1988).*

During the last several years, the NASD also has substantially increased its examination and enforcement efforts with respect to penny stock firms.[26] At the same time, many states have increased substantially the staff and budgets of their securities agencies [27] and have enacted legislation directed to sales practice abuses or prohibiting or substantially restricting the use of blank check offerings.

In August 1989, the Commission adopted Rule 15c2–6.[28] Rule 15c2–6, which became effective on January 1, 1990, was designed to combat fraudulent and manipulative practices by broker-dealers relating to certain low-priced securities that are traded outside of an exchange or an automated OTC quotation system ("designated securities"). In general, unless one or more of the transactional exemptions provided by the rule is available, the rule makes it unlawful for a broker or dealer to sell to or cause the purchase of designated securities by any person unless the broker-dealer has specifically approved the purchaser's account for transactions in designated securities and has received the purchaser's written agreement to the transaction.[29]

In connection with the adoption of Rule 15c2–6, the Commission noted the connection between abusive sales practices and a lack of widely available information concerning secondary market activity in penny stocks.[30] Further, the Commission determined that regulatory action was warranted in light of continuing broker-dealer misconduct and the expenditure of considerable resources in investigating and prosecuting illegal activities involving penny stocks, which often are time-consuming and involve complicated evidentiary problems.[31] Moreover, the Commission recognized that issuer disclosure, the NASD's customer suitability rule,[32] and the general antifraud provisions of the federal securities laws [33] do not by themselves provide investors with sufficient protection against the abusive practices found in the penny stock market.[34]

Certain other recent initiatives by the Commission and the NASD affect broker-dealer sales practices in the penny stock market and the availability of market information to investors and regulators. The Commission has adopted amendments to Rule 15c2–11 under the Exchange Act,[35] which governs the submission and publication of quotations by brokers or dealers for securities that are not traded on an exchange or the NASDAQ system ("non-NASDAQ securities"). Rule 15c2–11 focuses on the fraudulent and manipulative potential of OTC quotations, which may be published not only to induce trading in a security, but also to establish an "apparent value." [36] These amendments require, among other things, that a broker or dealer review specified information before initiating or resuming quotes in a quotation medium and have a reasonable basis under the circumstances for believing that the information is accurate in all material respects and obtained from reliable sources.[37]

In May 1990, the Commission approved a rule change by the NASD to establish a one-year pilot program testing a new OTC Bulletin Board Display Service ("OTC Bulletin Board"), designed to allow market makers in non-NASDAQ securities to provide real-time quotation information, including indications of interest, concerning those securities on an electronic interdealer system.[38] Participation by market makers in the system is voluntary. Unlike quotations in NASDAQ, quotations entered in the OTC Bulletin Board need not be firm [39] and may be limited to bid or offer quotes only. Further, information contained in the system is not currently transmitted to market data vendors or wire services for newspaper publication.

Schedule H to the NASD Bylaws, adopted in 1988,[40] requires dealers in non-NASDAQ securities to report daily transaction volume to the NASD but not to the public.[41] The OTC Bulletin Board and Schedule H enhance surveillance efforts to identify fraudulent and manipulative conduct by broker-dealers involving non-NASDAQ securities.

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[26] See 1989 Hearings at 77–80 (statement of the NASD);1990 Hearing at 145–158 (statement of the NASD). These efforts have been facilitated by the Commission's approval of the NASD's proposal to remove the ceiling on fines, previously set at $15,000, for violations by member firms of its rules. Securities Exchange Act Release No. 25999, 53 FR 31948 (August 16, 1988).

[27] Statement of John C. Baldwin, *supra* n. 16, at 129.

[28] 17 CFR 240.15c2–6.

[29] Rule 15c2–6 defines designated securities to include any equity security other than a security (1) registered, or approved for registration upon notice of issuance, on a national securities exchange that makes transaction reports available pursuant to Rule 11Aa3–1 under the Exchange Act; (2) authorized, or approved for authorization upon notice of issuance, for quotation on the NASDAQ system; (3) issued by an investment company registered under the Investment Company Act of 1940; (4) that is a put option or call option issued by the Options Clearing Corporation; or (5) issued by an issuer that has net tangible assets in excess of $2 million, as demonstrated by certain financial statements that have been reviewed by the broker-dealer. For a more detailed discussion of the definition of "designated security," see Rule 15c2–6 Adoption Release, 54 FR 35472–75. Specific transactional exemptions apply to: (1) transactions in which the price of the security is five dollars or more; (2) transactions in which the purchaser is an accredited investor or an established customer of the broker-dealer; (3) transactions that are not recommended by the broker-dealer; and (4) transactions by a broker-dealer that is not a market maker in the designated security that is the subject of the transaction, and which derives not more than five percent of its total securities sales-related revenue from transactions in designated securities. The NASD, in notices to its members, has published certain interpretations of the Commission's staff concerning the rule and a model Customer Suitability Statement and Agreement to Purchase Form. NASD Notices to Members No. 90–18 (March 19, 1990) and No. 90–65 (October 1990) at 365–371.

[30] 54 FR at 35470.

[31] Rule 15c2–6 Proposal Release, 54 FR at 6694.

[32] NASD Rules of Fair Practice, Art. III, section 2, NASD Manual (CCH) ¶2152 provides that: "In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."

[33] *E.g.*, section 12(2) of the Securities Act of 1933 (the "Securities Act") (imposing civil liabilities on persons offering or selling securities by means of fraudulent or misleading communications); section 17(a) of the Securities Act (making unlawful fraudulent practices related to the offer or sale of securities); and section 10(b) of the Exchange Act and Rule 10b–5 thereunder (making unlawful the use of manipulative and deceptive devices in connection with the purchase or sale of securities).

[34] Rule 15c2–6 Adoption Release, 54 FR at 35474; Rule15c2–6 Proposal Release, 54 FR at 6695–6. During March 1990, the Commission, the NASD, and the State of Florida conducted a special examination of penny stock broker-dealers in order to assess the level of compliance with the rule. See *Report By The Staff of The Securities and Exchange Commission On The Rule 15c2–6 Examination Sweep* (February 8, 1991). The monitoring of broker-dealer firms for compliance with Rule 15c2–6 is an integral part of the examination programs conducted by the Commission and the NASD.

[35] 17 CFR 240.15c2–11.

[36] See *Alessandrini & Co., Inc.*, 45 S.E.C. 399, 401(1973), *aff'd without opinion sub. nom. Budin* v. *SEC*, 506 F.2d 836 (2d Cir. 1974).

[37] Securities Exchange Act Release No. 29094, (April 17, 1991), also published in this issue of the **Federal Register.**

[38] Securities Exchange Act Release No. 27975 (May 1,1990), 55 FR 19124.

[39] The NASD has proposed to amend the system to require firm quotes. Securities Exchange Act Release No. 28946 (March 6, 1991), 56 FR 10932.

[40] Securities Exchange Act Release No. 25637 (May 2, 1988), 53 FR 16488.

[41] Members are required to report to the NASD on a daily basis, through an electronic price and volume reporting system, the highest price at which they sold and the lowest price at which they purchased any non-NASDAQ security, along with the total volume of shares purchased or sold. NASD Schedule to the Bylaws, Schedule H, § 2, NASD Manual (CCH) ¶1932–33 (1990). The NASD has proposed an amendment to Schedule H to remove the requirement that transactions in a security need be reported only where they exceed an aggregate daily volume of purchases or sales of either 50,000 shares or $10,000. Securities Exchange Act Release No. 28788 (January 16, 1991), 56 FR 2789.

III. Rules

A. General

The rules described in this release are being proposed by the Commission pursuant to the provisions of section 15(g) of the Exchange Act.[42] This section, which was added to the Exchange Act by section 505 of the Penny Stock Act, mandates specific measures to increase the level of disclosure to investors concerning penny stocks generally and specific penny stock transactions. In its report, the Committee stated:

> Because it is wrapped in secrecy and operates in relative obscurity, the penny stock market lends itself to manipulation far more easily than a market where information is readily available and circulated to investors. Penny stocks are often thinly traded and this more readily facilitates control and domination by a single market maker. The securities thus become attractive vehicles for manipulative, artificial schemes which are intended to raise the price or volume of the securities, primarily for the benefit of the few anonymous insiders, and frequently, the brokerage firm itself, which often unloads its own shares of the stock into the market after it has manipulated the price of the stock skyward.
>
> In the view of the Committee, the dearth of information in and about the penny stock market makes necessary the provisions in this legislation concerning the comprehensive new disclosure requirements for brokers and dealers in penny stocks * * *[43]

Section 503 of the Penny Stock Act added section 3(a)(51)[44] to the Exchange Act, which generally defines the term "penny stock" to include equity securities other than securities that are traded on exchanges or automated quotation systems meeting criteria established by the Commission, issued by registered investment companies, or otherwise excluded or exempted by the Commission based on price, net tangible assets, or other relevant criteria. Section 3(a)(51) also grants to the Commission certain additional authority to classify or exempt securities as penny stocks.

Under section 15(g)(1), it is unlawful for a broker or dealer to use the mails or other means of interstate commerce to effect, induce, or attempt to induce customer transactions in penny stocks except in accordance with the requirements of section 15(g) and the rules prescribed thereunder. In general, section 15(g): (i) Requires broker-dealers, prior to effecting a penny stock transaction, to provide to the customer a risk disclosure document that contains certain information describing the nature and level of risk in the penny stock market, the broker-dealer's duties to the customer, and the customer's rights and remedies for violations, as well as a narrative description of certain aspects of a dealer market generally, all in such form and containing such additional information as the Commission may require by rule; (ii) mandates that the Commission adopt rules relating to the disclosure, prior to each penny stock transaction and in the customer confirmation, of information concerning (A) price data, including bid and ask quotations, and the depth and liquidity of the market for particular securities and (B) the amount and a description of the compensation received by broker-dealers and their associated persons; (iii) calls for Commission rulemaking to require broker-dealers to provide for customers monthly account statements indicating the market value of the penny stocks in their accounts or indicating that the market value cannot be determined because of the unavailability of firm quotes; and (iv) provides the Commission with authority to adopt additional rules regarding disclosure by broker-dealers to their customers of information related to penny stock transactions.

Subsection 15(g)(4) provides the Commission with authority to exempt specific persons, or classes of persons, or transactions, or classes of transactions, from the requirements of section 15(g), consistent with the public interest and the protection of investors. Subsection 15(g)(5) grants to the Commission general rulemaking authority in order to carry out the purposes of the section or reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices with respect to penny stocks.

In addition to these broker-dealer disclosure requirements, the Penny Stock Act contains a number of other provisions involving penny stocks. Section 504 of the Penny Stock Act amended section 15(b)(6) of the Exchange Act[45] to provide to the Commission expanded authority to bar, suspend, censure, or place limitations on the activities of persons associated with or seeking to become associated with broker-dealers or other persons, such as promoters, who participate in a penny stock offering, where those persons have violated, or have been enjoined from violating, certain provisions of law. This provision addresses the Committee's determination that the Commission's sanctioning authority should be broad enough to encompass promoters, consultants, and similar participants in the penny stock market.[46] The Penny Stock Act also amended section 15A of the Exchange Act[47] to require every registered securities association to establish and maintain a toll-free telephone listing to receive public inquiries concerning broker-dealer disciplinary actions and to respond to those inquiries in writing.

In order to address the Committee's concern with the abuses often associated with blank check offerings, section 508 added to the Securities Act new subsection 7(b).[48] That subsection directs the Commission to adopt rules and regulations with respect to blank check offerings, which are defined as development stage companies that have no specific business plan or purpose or that intend to merge with an unidentified company or companies.[49]

In order to promote reliable and accurate market information concerning penny stocks, section 506 of the Penny Stock Act added new section 17B[50] to the Exchange Act to direct the Commission to facilitate the development of an automated quotation system to collect and disseminate reliable pricing and transaction information regarding penny stocks. The Commission believes that the NASD's OTC Bulletin Board is an important step in meeting this mandate, although the OTC Bulletin Board does not currently meet certain of the criteria, such as mandatory firm bid and ask quotations,[51] set forth in section 17B. The OTC Bulletin Board pilot period expires on May 31, 1991, and, in the context of reviewing an extension of the OTC Bulletin Board, the Commission will expect the NASD to address how the Bulletin Board may be further

[42] 15 U.S.C. 78*o*(g).

[43] House Report 20.

[44] 15 U.S.C. 78c(a)(51).

[45] 15 U.S.C. 78–*o*(b)(6).

[46] See section II.A. *supra*. Section 15(b)(6)(C) defines "person participating in an offering of penny stocks" to include "any person acting as any promoter, finder, consultant, agent, or other person who engages in activities with a broker, dealer, or issuer for purposes of the issuance or trading in any penny stock, or inducing or attempting to induce the purchase or sale of any penny stock," and such other activities as the Commission may determine.

[47] 15 U.S.C. 78*o*–3.

[48] 15 U.S.C. 77g(b).

[49] Pursuant to this directive, the Commission, by way of companion rulemaking, is proposing new rules under the Securities Act and the Exchange Act relating to registration statements filed by blank check companies offering penny stocks, including requirements to escrow securities issued and funds received in the offerings, and prohibiting the trading of securities that are held in escrow under these provisions. Securities Act Release No. 6891 (April 17, 1991), also published in this issue of the **Federal Register**.

[50] 15 U.S.C. 78q–2.

[51] The NASD has proposed to amend the system to require firm quotations. Securities Exchange Act Release No. 28946 (March 6, 1991), 56 FR 10932.

modified to meet section 17B's requirements.

Section 507 of the Penny Stock Act amended section 29(b) of the Exchange Act,[52] which controls the validity of contracts made in violation of the Exchange Act or the rules and regulations thereunder. The amendment provides that contracts made in violation of section 15(c)(2) of the Exchange Act or any rules adopted thereunder are void, except for such rules as the Commission by rule may specifically exempt from such application.[53]

B. Rule 3a51–1: Definition of Penny Stock

The Penny Stock Act added paragraph (51) to section 3(a) of the Exchange Act giving the Commission broad discretion to determine the scope of the securities covered under the Penny Stock Act. Section 3(a)(51)(A) defines the term "penny stock" as any equity security[54] other than a security that is (1) registered, or approved for registration, and traded on a national securities exchange that meets criteria prescribed by the Commission, (2) authorized for quotation on an automated quotation system sponsored by a registered securities association, if such system was established and in operation before January 1, 1990, and meets criteria prescribed by the Commission, (3) issued by an investment company registered under the Investment Company Act of 1940, or (4) excluded or exempted, on the basis of exceeding a minimum price, net tangible assets of the issuer, or other relevant criteria, from the definition of the term "penny stock" by rule or regulation prescribed by the Commission. This section determines both the extent of the Commission's authority under section 15(b)(6)(A) of the Exchange Act to censure, suspend, bar, or restrict the activities of persons participating in an offering of penny stock, and its authority to adopt rules under section 15(g) imposing additional broker-dealer disclosure requirements or other obligations with respect to penny stocks.

Pursuant to section 3(a)(51), the Commission is proposing Rule 3a51–1. Rule 3a51–1 generally would exclude from the definition of penny stock equity securities that are (1) reported securities, (2) put and call options issued by the Options Clearing Corporation, (3) priced at five dollars or more, or (4) registered on a national securities exchange or quoted on an automated quotation system that has specified maintenance listing criteria. The Commission also is proposing Rule 15g–1, which would exempt certain transactions from the disclosure requirements of Rules 15g–2 through 15g–6 under the Exchange Act. In proposing these rules, the Commission has considered the exclusions from the definition of "designated security" and the exempt transactions contained in Rule 15c2–6.[55] However, because the Penny Stock Act requires the Commission to conduct a separate and distinct analysis in defining the term "penny stock," and to identify independently transactions that are not likely to be the subject of manipulation,[56] the proposed definition of penny stock in Rule 3a51–1 and the transactions exempted under Rule 15g–1 are both broader and narrower in some respects than the analogous provisions of Rule 15c2–6.

1. Reported Securities

Paragraph (a) of proposed Rule 3a51–1 would exclude from the definition of penny stock any equity security that is a reported security—that is, any exchange-listed or NASDAQ security for which transaction reports are required to be made on a real-time basis pursuant to an effective transaction reporting plan.[57] As discussed above, many of the abuses occurring in the penny stock market are a direct result of the lack of publicly available information about the market in general and about the price and trading volume of particular penny stocks. Investors who lack access to this type of information are less able to make an informed investment decision, and thus are more susceptible to the manipulative sales practices of unscrupulous broker-dealers. In contrast, securities that are traded in a market that is subject to a comprehensive regulatory scheme requiring real-time transaction reporting and the extensive surveillance systems that this reporting supports, are less likely to be purchased or sold by means of manipulative sales tactics. Reported securities, in particular, are subject to a number of rules that promote efficient pricing and transaction execution procedures and mechanisms, and that generate public information for evaluation by professional securities analysts and the financial press.[58] These

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[52] 15 U.S.C. 78cc(b).

[53] The Penny Stock Act also substantially expands the Commission's administrative authority and civil enforcement powers. These provisions (the "remedies provisions") are not directly related to the penny stock provisions described above but will provide important new tools that the Commission can use to combat penny stock fraud and other violations of the federal securities laws. The remedies provisions were enacted to increase the deterrent effect of the Commission's enforcement actions and to provide the Commission with greater flexibility to fashion enforcement remedies in proportion to the seriousness of the violation. See Statement of Chairman Breeden, 1990 Hearing 36–44. See generally House Comm. on Energy and Commerce, *Report to accompany the Securities Law Enforcement Remedies Act of 1990*, H.R. Rep. No. 616, 101st Cong. 2d Sess. (July 23, 1990).

[54] The term "equity security" is defined in Section 3(a)(11) of the Exchange Act, 15 U.S.C. 78c(a)(11), as: "any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security."

Rule 3a11–1, 17 CFR 240.3a11–1, further defines "equity security" to include: "any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so."

[55] *See discussion of Rule 15c2–6, supra*, at section II.B. of this release. Unless otherwise indicated in this release, the Commission staff's interpretations of Rule 15c2–6 in part B of the NASD's Special Notice to Members No. 90–18 (March 19, 1990) ("NASD Notice") also would apply to any provisions of Rules 3a51–1 and 15g–1 that are the same as the provisions of Rule 15c2–6.

[56] See House Report at 27.

[57] 17 CFR 240.11Aa3–1(a)(4).

[58] For example, Rule 11Aa3–1 under the Exchange Act, 17 CFR 240.11Aa3–1, requires each exchange to file with the Commission, for approval, a transaction reporting plan concerning transactions by its members in reported securities effected through the facilities of the exchange. Each securities association is required to file a transaction reporting plan regarding transactions in reported securities by its members that are effected otherwise than through an exchange. The rule also provides for the collection and processing of transaction reports and last sale data and the consolidation of this information with similar information derived from other exchanges or national securities associations. Rule 11Ac1–1, 17 CFR 240.11Ac1–1, requires national securities exchanges or associations to establish and adopt procedures and mechanisms for collecting and processing bid, offer, and quotation size information for any reported security that is a "subject security," as defined in the rule, and for making this information available to quotation vendors. Members of an exchange or OTC market makers providing quotations in securities covered by the rule are obligated to communicate their bids, offers, and quotation sizes to their respective exchange or association. Subject to certain conditions, these broker-dealers also must execute transactions in such securities at a price at least as favorable as

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rules ensure that market information for reported securities is efficiently processed and disseminated to the public.

Reported securities also are required to meet strict listing criteria under the Restated Consolidated Tape Association Plan ("CTA Plan").[59] The CTA Plan generally provides that only securities that are registered or admitted to unlisted trading privileges on a national securities exchange and that satisfy NYSE or Amex original listing criteria, including such securities traded on a regional securities exchange, are reported securities.[60] In addition, only those securities quoted on NASDAQ that meet certain quantitative designation criteria are considered to be reported securities.[61] Accordingly, reported securities tend to represent issuers that have demonstrated an actual earnings history and potential and that have generated significant shareholder interest and acceptance. The Commission therefore proposes to exclude reported securities from the definition of penny stock because they are of a quality and are traded in a manner that make the protections provided by the Penny Stock Act less necessary.

Non-reported securities, such as securities that are quoted on NASDAQ but that are not designated as NMS securities, however, would be included within the definition of penny stock.[62] In the Rule 15c2–6 Adopting Release, the Commission recognized that, despite the protections afforded by quotation reporting and the surveillance systems operated by the NASD, sales practice abuses and manipulation similar to those in the non-NASDAQ OTC market also can occur in the market for non-NMS NASDAQ securities.[63] Since the adoption of Rule 15c2–6, the Commission has had the opportunity to monitor fraudulent sales practices in the NASDAQ markets. The Commission preliminarily believes that incidences of fraudulent activity involving low-priced non-NMS NASDAQ securities and other securities that are not subject to last sale reporting are sufficient to justify their inclusion in the definition of penny stock.[64] For instance, in attempting to generate substantial trading volume in low-priced stocks, broker-dealer representatives often make inflated claims concerning an issuer or the value of a security. Non-reported securities that are traded in the OTC market are particularly susceptible to such manipulation due to the lack of information regarding last sales and due to their low price.

The definition of penny stock also would include non-reported securities listed on a regional exchange. There is some indication that penny stock issuers and sponsors recently have listed securities on the regional exchanges to avoid the application of Rule 15c2–6. Notwithstanding these listings, virtually all of the trading volume in these securities has continued to occur in the OTC "pink sheet" market.[65] Thus, the Commission proposes to cover non-reported securities, including those securities listed on an exchange or quoted on NASDAQ, within the definition of penny stock.

By defining the term "penny stock" to include such low-priced non-reported securities, the Commission would retain the authority to bar certain persons, as described in section 15(b)(6)(A) of the Exchange Act, from participating in a wide range of low-priced securities offerings. Specifically, under section 15(b)(6)(A), the Commission would have the authority to prohibit any person subject to a Commission order barring or suspending that person from participating in a distribution of penny stock, as defined in Rule 3a51–1, from associating or seeking to become associated with a broker-dealer or from participating in a distribution of penny stock, without the consent of the Commission. Broker-dealers also would be prohibited under this section from participating in a distribution of penny stock without the Commission's consent if, in the exercise of reasonable care, they are aware of, or should have been aware of, the participation of a barred person.[66]

Proposed Rule 3a51–1 thus would give the Commission broader prescriptive authority to address problems of recidivism in penny stock offerings, including offerings of low-priced non-reported securities quoted on NASDAQ or registered on a regional securities exchange. Pursuant to section 15(g)(5) of the Exchange Act, it also would give the Commission general rulemaking authority with respect to those securities to promulgate any rules that are necessary or appropriate for the protection of investors or the maintenance of fair and orderly markets, or that are designed to prevent fraudulent or deceptive acts and practices. As discussed below, however, because quotations are available for securities quoted in the NASDAQ system or registered on a national exchange, proposed Rule 15g–1 would exempt transactions in these securities from Rule 15g–3, which requires broker-dealers to disclose quotations and other

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their communicated bids or offers, up to the amount of the communicated quotation size. For further discussion of transaction reporting, *see infra*, at section III.C.6. of this release.

[59] Securities Exchange Act Release No. 16983 (July 16, 1980), 45 FR 49414.

[60] As a general rule, the qualification standards of the NYSE require issuers to demonstrate that they have a total of 1,100,000 publicly-held shares and that the aggregate market value of those shares is $18,000,000. NYSE Rules, sec. 1 §§ 101.00–103.01, NYSE Guide (CCH) ¶¶ 2501–2606. Under the listing requirements of the Amex, issuers generally must have stockholders' equity of at least $4,000,000, and pre-tax income of at least $750,000 in the issuer's last fiscal year or in two of its last three fiscal years. Amex Rules, part 1 §§101–118, Amex Guide (CCH) ¶¶10,001–10,018. Apart from minimum numerical standards, both exchanges also will take other factors into consideration. For example, the Amex rules state that "[o]ther factors which will also be considered include the nature of a company's business, the market for its products, the reputation of its management, its historical record and pattern of growth, its financial integrity, its demonstrated earning power and its future outlook." Amex Rules, part 1 § 101, Amex Guide (CCH) ¶ 10,001.

[61] Issuers of these securities, which are known as NASDAQ/NMS securities, generally are required, among other things, to have either (1) $4,000,000 in net tangible assets and an annual pre-tax income of at least $750,000, or (2) $12,000,000 in net tangible assets and an operating history of three or more years. NASD Schedules to the By-Laws, Schedule D, pt. III, § 2 NASD Manual (CCH) ¶ 1809. See also the National Market System Securities Designation Plan With Respect To NASDAQ Securities, Securities Exchange Act Release Nos. 18399 (January 7, 1982), 47 FR 2228, and 22665 (November 26, 1985), 50 FR 49642.

In 1989, there were approximately 2,697 securities quoted on NASDAQ subject to last sale reporting. NASDAQ Fact Book (1990), at 44.

[62] According to the NASD, as of February 28, 1991, there were 2,097 non-NMS NASDAQ securities; of these securities, 837 were priced at less than five dollars and issued by an issuer with less than $2,000,000 in net tangible assets. The majority of these securities are securities that would have been subject to the requirements of Rule 15c2–6 if not for their quotation on NASDAQ.

[63] 54 FR at 35473.

[64] See, *e.g.*, *SEC* v. *Michael Kaufman*, Litigation Release No. 12425 (March 27, 1990); *SEC* v. *Novaferon Labs, Inc.*, Litigation Release No. 12745 (Dec. 21, 1990); *Cowen & Co.* v. *Merriam*, 745 F. Supp. 925 (S.D. N.Y. 1990); *Market Surveillance Committee* v. *Haas Securities Corp.*, No. MS–675 (NASD Nov. 25, 1988); *SEC* v. *James L. Condron*, Litigation Release No. 10687 (Feb. 25, 1985); *Alstead, Strangis & Dempsey, Inc.*, 47 S.E.C. 1034 (1984); and *SEC* v. *United Greenwood Explorations Ltd.*, Litigation Release No. 10131 (Sept. 23, 1983).

In connection with Rule 15c2–6, several commentators suggested that, due to the high risk of failure among certain minimally capitalized issuers, the protections provided by Rule 15c2–6 should apply to all transactions in securities issued by companies failing to meet a minimum level of net tangible assets, regardless of whether the securities are traded on an exchange or on NASDAQ. The Commission requests comment on whether Rule 3a51–1 should be more broadly drafted to include securities of issuers failing to meet specified financial standards.

[65] See, *e.g.*, D. Henriques, *The Latest Penny-Stock Shuffle*, The New York Times, April 1, 1990, sec. 3 at 1. For further discussion of exchange-listed and NASDAQ securities that are traded primarily in the OTC "pink sheet" market, see discussion, *infra*, at section III.C.6. of this release.

[66] See House Report at 28.

market information with respect to transactions in penny stocks, as well as Rules 15g–2 and 15g–6, which require broker-dealers to provide a risk disclosure document and account statements to purchasers of penny stocks. [67]

2. Price of the Security

As proposed, Rule 3a51–1 also would define penny stock to exclude securities that are priced at five dollars or more. For purposes of the rule, the price of a security in an agency transaction or a contemporaneous offsetting purchase and sale principal transaction [68] would be the price exclusive of any broker-dealer commission, commission equivalent, mark-up, or mark-down. In all other principal transactions, the price would be the price inclusive of the amount of the broker-dealer's mark-up or mark-down. [69]

In addition, paragraph (d)(1)(i) of the rule would provide that a security has a price of five dollars or more for a particular transaction if it is purchased or sold in a transaction at a price of five dollars or more. [70] Thus, the price of the security in an individual transaction will determine whether the security is a penny stock for purposes of that transaction. In the absence of a transaction, paragraph (d)(1)(ii) of the rule would provide that a security has a price of five dollars or more only if: (1) The average of at least three *bona fide* independent interdealer bid quotations at specified prices displayed in an interdealer quotation system [71] by market makers in the security to which the quotations apply is five dollars or more; or (2) a *bona fide* independent bid quotation published by a national securities exchange that makes transaction reports available pursuant to Rule 11Aa3–1 is five dollars or more. The purpose of paragraph (d)(1)(ii) is to allow persons to determine the price of a security if that security has not been or will not be purchased or sold in a particular transaction. [72] Because quotations for low-priced non-reported securities frequently are the subject of negotiation and may not accurately reflect the prevailing market price, the rule includes a condition that there be at least three *bona fide* independent bid quotations displayed in an interdealer quotation system at the time the determination whether the particular security is a penny stock is being made. These bid quotations may not be entered in the quotation system by broker-dealers acting in concert to circumvent the requirements of the rule. Alternatively, the rule would allow the five dollar price to be established by a *bona fide* bid quotation published by a transaction-reporting exchange. In the case of a unit composed of different securities, the price divided by the number of shares of the unit that are not warrants, options, rights, or similar securities, must be five dollars or more, as determined in accordance with paragraph (d)(1) of the rule, and the exercise price of any warrant, option, or right, as well as the conversion price of any convertible security, included in the unit must be five dollars or more. [73]

The five dollar figure, which is derived from Rule 15c2–6, is intended to include as penny stocks only those low-priced securities that, in the Commission's view, are the most susceptible to fraudulent sales practices. Although securities priced at any level can be the subject of market manipulation, broker-dealers frequently use securities selling for under five dollars, especially those trading at prices less than one dollar, in manipulative schemes due to the potential for rapid profits. For example, as the Commission noted in connection with Rule 15c2–6, "if a stock is quoted at five cents bid and ten cents asked, the spread, while only five cents in amount, constitutes a potential 100% profit per share to the broker-dealer." [74] In fact, if the market for a penny stock is dominated and controlled by a broker-dealer that sets an arbitrary price, the per share profit to the broker-dealer may be much higher than the actual spread. [75] In contrast, percentage price spreads in securities priced above five dollars generally are much lower. [76]

By setting the minimum price at five dollars, the proposed rule also is intended to avoid inhibiting legitimate small business capital formation. The five dollar figure is consistent with the Uniform Limited Offering Registration ("ULOR") project developed by the State Regulation of Securities Committee of the American Bar Association to provide a short-form registration procedure for small business private offerings. [77] Thus, small issuers may avoid the requirements of the Penny Stock Act by either adjusting their capital structure and pricing their securities at five dollars or more, or by relying on an exemption from the section 15(g) disclosure rules, described below.

3. Qualification Standards

Finally, paragraph (e) of proposed Rule 3a51–1 would exclude from the definition of penny stock any security that is registered, or approved for registration upon notice of issuance, on a national securities exchange that makes transaction reports available

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[67] For a discussion of these proposed rules, see *infra*, at sections III.D.—III.I. of this release.

[68] *I.e.*, transactions effected by a broker-dealer for a customer on a basis other than as a market maker in the security where, after having received an order from the customer to purchase the security the dealer effects the purchase from another person to offset a contemporaneous sale of the security to such customer, or, having received an order from the customer to sell the security, the dealer effects the sale to another person to offset a contemporaneous purchase from such customer.

[69] The Commission staff also has interpreted the five dollar price exemption with respect to principal transactions under Rule 15c2–6 to include mark-ups. See NASD Notice, Question No. 15. As in Rule 15c2–6, a broker-dealer would not be allowed under Rule 3a51–1(d) to charge an excessive mark-up in order to avoid the application of the penny stock rules.

Furthermore, information regarding broker-dealer mark-ups and mark-downs with respect to penny stocks traded under five dollars would be required to be disclosed to customers pursuant to proposed Rule 15g–4.

[70] Conversely, a security that is purchased or sold in a particular transaction at a price of less than five dollars, and that is not otherwise excluded from the definition, would be deemed to be a penny stock.

[71] Inter-dealer quotation system is defined in 17 CFR 240.15c2–7(c)(1) as "any system of general circulation to brokers and dealers which regularly disseminates quotations of identified brokers or dealers but shall not include a quotation sheet prepared and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer."

[72] For instance, promoters, consultants, or other associated persons of a broker-dealer or issuer that have been barred pursuant to section 15(b)(6) of the Exchange Act from participating in penny stock transactions may rely on paragraph (d)(1)(ii) to determine whether a particular security would be deemed to be a penny stock for purposes of section 15(b)(6).

[73] For example, a unit composed of five shares of common stock and five warrants would satisfy the requirements of this paragraph only if the unit price was twenty-five dollars or more, and the warrant exercise price was five dollars or more. Once the components of the unit begin trading separately on the secondary market, they must each be separately priced at five dollars or more.

Because interests in limited partnerships, real estate investment trusts, preferred stock, and certain types of asset-backed securities usually are priced at far more than five dollars, as a general rule, they also would be excluded from application of the penny stock rules under this provision.

[74] 54 FR at 35489. See also House Report at 12.

[75] See House Report at 11. In most cases, this practice would violate the antifraud provisions of the securities laws, such as Rule 10b–5 under the Exchange Act, 17 CFR 240.10b–5, as well as SRO rules of fair practice. See, e.g., NASD Rules of Fair Practice, Art. III, § 2 NASD Manual (CCH) ¶ 2152.

[76] See 54 FR at 35475.

[77] Specifically, ULOR provides a streamlined registration procedure for small businesses raising less than $1,000,000 in offerings exempt from registration under Rule 504 of Regulation D, 17 CFR 230.504. In order to prevent abuses in the secondary market in securities issued pursuant to ULOR, as a general rule, issuers may only apply for ULOR registration if the offering price of their common stock, or the exercise or conversion price of any warrants, options, rights, or convertible securities included in the offering, is more than five dollars. See 54 FR 35475.

pursuant to Rule 11Aa3–1,[78] and that, at a minimum, has the authority to delist or to withdraw a security from registration if the issuer's net tangible assets or stockholder equity falls below $2,000,000. Only securities that are actually traded on an exchange meeting these criteria would be excluded from the term "penny stock."[79] Currently, the maintenance criteria of the NYSE, the Amex, and the CBOE satisfy the requirements of the proposed rule.[80]

The maintenance criteria in paragraph (e) are derived from the criteria for reported securities set out in the CTA Plan.[81] Thus, the rule ensures that only registered securities representing companies that are a going concern, that have generated significant shareholder interest, and that are subject to certain Commission rules designed to prevent the types of abuses that typically occur in the penny stock market, would be excluded from the definition of penny stock. Although only a few national securities exchanges now qualify for this exclusion, the Commission believes the proposed maintenance criteria in paragraph (e) potentially would allow other securities exchanges to amend their maintenance standards to exclude their registered securities from the definition of penny stock if the requirements of the Penny Stock Act should prove a hindrance to trading in their securities.[82] The Commission also believes that these standards for exchange-listed securities are consistent with the statement in the House Report that "[t]he Committee expects the Commission to consider [real-time transaction reporting] plans in connection with any particular qualifying criteria the Commission may establish respecting the adequacy of reporting by exchanges for purposes of subparagraph (51)(A)."[83]

For the same reasons, paragraph (f) of Rule 3a51–1 would exclude any security that is authorized, or approved for authorization upon notice of issuance, for quotation in the NASDAQ system, provided that the system meets the same criteria. Although the maintenance criteria required by NASDAQ currently does not meet the Commission's proposed criteria, securities designated as NASDAQ/NMS securities would be excluded from the definition of penny stock pursuant to the exclusion in paragraph (a) for reported securities.[84]

C. Rule 15g–1: Exemptions from Proposed Rules

The Commission recognizes that, while the rules proposed pursuant to section 15(g) of the Exchange Act are directed at those low-priced securities that are the most susceptible to manipulative sales practices, the rules may affect legitimate small business capital formation. The Commission therefore is proposing Rule 15g–1, which would exempt certain transactions from the broker-dealer disclosure requirements of Rules 15g–2 through 15g–6.

1. Limited Broker-Dealer Activity in Penny Stocks

Section 15(g)(4) of the Exchange Act, which gives the Commission the authority to exempt any person or transactions from the rules adopted pursuant to section 15(g), requires the Commission to include an exemption for brokers-dealers that derive only an insignificant percentage of their total revenue from transactions in penny stocks. Accordingly, the Commission is proposing to exempt from Rules 15g–2 through 15g–6 transactions in penny stocks by broker-dealers that derive less than five percent of their total revenue from sales of penny stocks, except when they are acting as a market maker in the penny stock that is the subject of the transaction.[85] As with Rule 15c2–6, the Commission believes that making a market in a security creates an incentive for high pressure sales tactics, as well as an opportunity to manipulate the price of the security.[86] Therefore, regardless of their percentage of revenue from penny stock transactions, market makers in a penny stock would not be exempt under Rule 15g–1 with respect to that particular penny stock. Moreover, although this exemption is similar to paragraph (c)(4) of Rule 15c2–6, it is based on transactions in penny stocks, as defined in Rule 3a51–1, rather than transactions in "designated securities," as defined in Rule 15c2–6.[87]

2. Net Tangible Assets

Rule 15g–1(a) also would exempt from Rules 15g–2 through 15g–6 transactions in penny stocks issued by an issuer that meets minimum financial standards, as demonstrated by recent audited financial statements. Specifically, the rule would exempt an issuer that has been in continuous operation for at least three years if it has a minimum of $2,000,000 in net tangible assets. An issuer that has been in operation for less than three years must have net tangible assets in excess of $5,000,000 in order for the exemption to apply.[88]

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[78] 17 CFR 240.11Aa3–1.

[79] For further discussion of exchange-listed securities that are traded outside the parameters of the exchange, see discussion, *infra*, at section III.C.6. of this release.

[80] See NYSE Rules, sec. 8 § 802.00, NYSE Guide (CCH) ¶ 2565; Amex Rules, Part 10 § 1003, Amex Guide (CCH) ¶ 10,377; and CBOE Rules, ch. XXXI, Rule 31.94(C), CBOE Guide (CCH) ¶ 4094.

Because put and call options issued by the Options Clearing Corporation are already subject to special disclosure requirements, they are separately excluded from the definition of penny stock in paragraph (c) of Rule 3a51–1. See, *e.g.*, 17 CFR 240.9b–1; CBOE Rules, ch. IX, Rules 9.1–9.23, CBOE Guide (CCH) ¶ 2301–23; and NASD Rules of Fair Practice, appendix E, NASD Manual (CCH) ¶ 2164.

[81] In general, the CTA Plan incorporates the listing standards of the NYSE and the Amex. See discussion, *supra*, at section III.B.1. of this release.

[82] In order to qualify for this exclusion, the national securities exchange would be required to actually enforce either the $2,000,000 maintenance standard or a higher standard.

[83] House Report 28.

[84] The securities of approximately 3,350 publicly-traded corporations are listed on either the NYSE or the Amex. An additional 4,970 issues are quoted in the NASDAQ system; of these securities, approximately only one-half qualify as NASDAQ/NMS securities. See House Report at 8.

The NASD has filed a proposed rule change with the Commission pursuant to section 19(b) and Rule 19b–4 of the Exchange Act, to impose more stringent conditions for initial and continued inclusion of securities in the NASDAQ system. Pursuant to this proposal, a number of securities that are currently quoted, or that are eligible for quotation, in the NASDAQ system would become ineligible for continued quotation. See Securities Exchange Act Release Nos. 28391 (August 29, 1990), 55 FR 36372, 27908 (April 13, 1990), 55 FR 15052. These new conditions still would not satisfy the criteria for automated quotation systems proposed in Rule 3a51–1(f).

[85] Specifically, the rule would exempt transactions by a broker-dealer whose commissions, commission-equivalents, mark-ups, and mark-downs from transactions in penny stocks during each of the immediately preceding three months, and during eleven or more of the preceding twelve months, did not exceed five percent of its total commissions, commission equivalents, mark-ups, and mark-downs from transactions in securities during those months. A broker-dealer would have a ten-day period after the end of each month to determine whether it continued to meet the five percent sales-related revenue exemption. *Cf.* Letter from Robert L.D. Colby, Chief Counsel, Division of Market Regulation, SEC, to Michael W. Schley, Esq., Mahoney, Walling & Kelley (December 21, 1989).

[86] See 54 FR at 35477.

[87] Unlike proposed Rule 3a51–1, the definition of the term "designated security" in Rule 15c2–6 excludes any security that is registered on a national securities exchange that makes transaction reports available pursuant to Rule 11Aa3–1, that is authorized for quotation on NASDAQ, or whose issuer has net tangible assets in excess of $2,000,000. Although, as a general rule, low-priced securities are included within the definition of "designated security," transactions in securities priced at five dollars or more are exempt from Rule 15c2–6. For further discussion of Rule 15c2–6, see discussion at section II.B. of this release.

The Commission is considering amending Rule 15c2–6 to conform the scope of the rule to the penny stock rules promulgated under the Penny Stock Act. See discussion *infra*, at section IV of this release.

[88] In calculating the number of years in which it has been in operation, an issuer may "tack" on the period of time during which its predecessor remained in operation, provided that the issuer is a legitimate successor of that predecessor; that is, the business, ownership, and control of the issuer must

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This exemption is based on a similar provision in Rule 15c2–6 excluding any security whose issuer has net tangible assets of more than $2,000,000 from the definition of "designated security." [89] Unlike Rule 15c2–6, however, Rule 15g–1(a)(2) would impose a separate higher standard for issuers that have been in operation for less than three years in order to prevent start-up companies from inflating their assets or merging with companies with inflated assets to meet the minimum financial standards of the rule.[90] In particular, the two-tier standard is designed to prevent the types of abusive activities that have occurred both prior to and since the adoption of Rule 15c2–6 in August of 1989. For instance, it appears that some issuers have materially overstated their assets by falsely reporting fictitious items or receivables as assets. In other instances, broker-dealers have improperly subtracted intangible assets from total assets without reducing that amount by the issuers' outstanding liabilities. Start-up companies are particularly susceptible to these types of practices because they have little or no verifiable financial history. Therefore, in order to make more difficult similar abuses or evasions of Rule 15g–1, the Commission would retain Rule 15c2–6's $2,000,000 standard for companies in operation for over three years, but would increase the standard to $5,000,000 for companies that have a shorter or no operating history.[91]

The rule would further provide that, for domestic issuers, the required level of net tangible assets be demonstrated by financial statements dated less than fifteen months prior to the date of the transaction that have been audited and reported on by an independent accountant in accordance with Regulation S–K.[92] For foreign private issuers, the rule would require net tangible assets to be demonstrated by financial statements that are dated less than fifteen months prior to the date of the transaction, and that have been filed with the Commission or furnished to the Commission pursuant to Rule 12g3–2(b).[93] If the foreign private issuer has not been required to file or furnish financial statements during the previous fifteen months, however, the financial statements may be prepared and audited in compliance with generally accepted accounting principles of the country of incorporation and reported on by an accountant registered and in good standing in accordance with the regulations of that jurisdiction. [94] To demonstrate compliance with the rule, broker-dealers would be required to keep copies of the domestic or foreign issuer's financial statements for at least three years, the first two of which must be in an easily accessible place.[95]

In all cases, the broker-dealer must review the financial statements and have a reasonable basis for believing that they were accurate as of their date and that the issuer's financial condition has not substantially changed at the date of the transaction. Specifically, the broker-dealer must obtain audited financial statements from a reliable source, such as the issuer or the Commission, and review those statements to ensure that the issuer's assets less intangible assets and liabilities equals the amount required by the rule.[96] Ordinarily, if the issuer's audited statements show net tangible assets equaling either $2,000,000 or $5,000,000, depending on the number of years the issuer has been in operation, the broker-dealer will be entitled to rely on those statements to establish an exemption under the rule. Therefore, in most cases, the broker-dealer need not inquire about or conduct research with respect to any of the information contained in the issuer's financial statements. If, however, materially inconsistent or inaccurate information appears on the face of the financial statements, or if the broker-dealer becomes aware, in the course of its review, of material inconsistencies between the statements and information in the broker-dealer's possession, the broker-dealer may not claim an exemption based on those statements until it has satisfied itself that the information contained therein was accurate and complete as of the date of the financial statements and that the issuer's financial condition has not substantially changed.[97] The way in which the broker-dealer may satisfy itself as to the accuracy of an issuer's financial statements under the rule will vary according to the circumstances.[98] The rule, however, would not require the type of "due diligence" investigation typically required of an underwriter.

3. Institutional Accredited Investors

Paragraph (a) of Rule 15g–1 also would exempt transactions in which the customer is an institutional accredited investor, as defined in Regulation D of

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be closely related to that of its predecessor. A merger or other form of reorganization between two companies solely for the purpose of circumventing the requirements of the rule would not be considered a legitimate predecessor-successor relationship.

[89] 17 CFR 240.15c2–6(d)(2)(v).

[90] As a recent article noted, "[a]s soon as the cold-call rules went into effect, issuers and brokers found ways to circumvent them, including * * * mergers that would produce the required $2 million in assets." D. Henriques, *The Scam Goes On*, The New York Times Magazine, September 23, 1990, at 32. See also *Report by the staff of the Securities and Exchange Commission on the Rule 15c2–6 Examination Sweep* (February 8, 1991). The Commission's examination report states that in up to twelve percent of the examinations, a broker-dealer had incorrectly relied on the "designated security" definitional exclusion for issuers with more than $2,000,000 in net tangible assets. In addition, the examination report found that in many cases, "the broker-dealer had * * * subtracted intangible assets from total assets without reducing this amount by the issuer's outstanding liabilities." Examination report at 6, n.13. See also, generally, *United States* v. *John Robert Frascone*, Litigation Release No. 12666 (October 11, 1990); *SEC* v. *San Marino Securities, Inc.*, Securities Exchange Act Release No. 28487 (September 28, 1990), Examination report at 11; *SEC* v. *Wainwright, Austin, Stone & Co.*, Securities Exchange Act Release No. 28695 (December 13, 1990), Examination report at 12; *SEC* v. *Harry Schreiber*, Litigation Release No. 12216 (August 14, 1989); *United States* v. *Gleave*, Litigation Release No. 12024 (March 8, 1989); *SEC* v. *Intercontinental Technologies Corp.*, Litigation Release No. 10455 (July 12, 1984); and *SEC* v. *Wellshire Securities, Inc.*, 737 F. Supp. 251 (SDNY 1990).

In light of these practices, the Commission solicits comment on whether the $5,000,000 net tangible assets standard in proposed Rule 15g–1 should apply to all issuers, regardless of their number of years in business.

[91] A two-tier standard has been adopted in several other contexts involving issuer qualification standards. See, e.g., NASD Schedules to the By-Laws, Schedule D, pt. III, § 2 NASD Manual (CCH) ¶ 1809; and Amex Rules, part 10 § 1003, Amex Guide (CCH) ¶ 10,377.

[92] 17 CFR 210.2–02.

[93] 17 CFR 240.12g3–2(b). Securities Exchange Act Release No. 28889 (February 22, 1991), 56 FR 7424, provides a list of foreign issuers that have submitted the information required by Rule 12g3–2(b) to date.

[94] Although this language is derived from Rule 15c2–6, it has been amended to clarify that financial statements prepared in accordance with the accounting principles of a foreign jurisdiction will only be accepted if recent financial statements are not required to be and have not been filed with or furnished to the Commission.

[95] See 17 CFR 240.17a–4(b).

[96] The calculation would be the same as the calculation of net tangible book value under Item 506 of Regulation S–K, 17 CFR 229.506. The definition of intangible assets is addressed in Accounting Principles Board Opinion No. 17 (August, 1970).

[97] For further discussion of what constitutes a "reasonable basis for believing" that information is accurate, see Securities Exchange Act Release No. 29094 (April 17, 1991) (also published in this issue of the **Federal Register**), adopting amendments to Rule 15c2–11. This release discusses the types of "red flags" that generally should call into question information that has been provided to a broker-dealer. For instance, the release cites, as an example of a "red flag," financial statements of a development stage issuer that lists as the principal component of its net worth an asset that is wholly unrelated to the issuer's line of business.

[98] For example, the broker-dealer may directly question the issuer or its accountant. Under no circumstances, however, may the broker-dealer rely on information from any outside source, such as the issuer, to establish an exemption under the rule if the issuer's audited financial statements do not *clearly* indicate that the issuer had the required amount of net tangible assets at the date of the financial statements.

the Securities Act of 1933.[99] Thus, Rules 15g–2 through 15g–6 generally would not apply if the purchaser or seller of the penny stock is an institution, such as a bank, a registered broker-dealer, an employee benefit plan, a large corporation, or similar entity. These institutional investors usually invest in speculative equity securities only as part of a general business plan. As a result, they generally have a good understanding of the risks of investing in penny stocks. Moreover, in making investment decisions, these types of investors usually have the ability to obtain and evaluate independent information regarding penny stocks. They therefore are less susceptible to manipulative high pressure sales tactics and are less in need of the particular protections provided by proposed Rules 15g–2 through 15g–6.

Rules 15g–2 through 15g–6, however, would still apply to individual accredited investors.[100] Individual investors are more frequently the target of high pressure sales techniques because they present a better opportunity for sales of speculative equity securities. Given the nature of the penny stock market, the greater affluence of individual accredited investors provides little advantage in assessing the merits of penny stocks. These investors, for instance, often have few means of independently verifying the information provided by a penny stock broker-dealer.[101] As a result, they remain susceptible to abusive sales practices.

The penny stock disclosure rules are meant to benefit individual accredited investors by redressing this information imbalance. For example, many individual investors are unaware that the markets for a large number of penny stocks are dominated by a single market maker. Proposed Rule 15g–7 would require broker-dealers to disclose when they (or their affiliates) are acting as the sole market maker with respect to the penny stock that is the subject of the transaction and would prohibit market makers in a penny stock (or their affiliates) from making certain unwarranted representations about the price of the security. Rules 15g–2 through 15g–6 also would require broker-dealers to disclose other information that would assist an individual in making an informed investment decision, such as information regarding the risks involved in investing in the penny stock market, quotations and other relevant market information, and the amount of compensation received by the broker-dealer and any associated persons of the broker-dealer in connection with the penny stock transaction.[102]

4. Non-Recommended Transactions

As in Rule 15c2–6, Rule 15g–1(a) would exempt transactions in penny stocks that are not recommended by a broker-dealer. Investors who, on their own initiative and absent any recommendation from a broker-dealer, decide to purchase or sell a penny stock presumably are aware of and willing to assume the risks of trading in the penny stock market. Moreover, many of these investors have previous trading experience in penny stocks and knowledge of the business practices of their broker-dealers, and so are less in need of the protections provided by the rules.

The exemption in paragraph (a)(4) of the rule for non-recommended transactions generally is limited to situations in which a broker-dealer acts as an order taker for the customer, with little or no incentive to engage in manipulative sales tactics. It would not, for instance, apply to situations in which a broker-dealer brings a penny stock to the attention of an investor who subsequently purchases that penny stock, nor would it apply to situations in which the broker-dealer recommends a penny stock by sending promotional material through the mail directly to a particular investor.[103]

5. Issuer Repurchases

Finally, paragraph (a)(5) of Rule 15g–1 would exempt transactions by an issuer repurchasing or redeeming its own securities. Corporations generally repurchase their outstanding securities as part of a specific business plan.[104] For example, a corporation may decide to increase the earnings of its remaining shareholders by repurchasing some of its securities; or a corporation that is a party to a merger or sale of assets may

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[99] 17 CFR 230.501(a)(1), (2), (3), (7), or (8). Under these provisions, an "accredited investor" is defined as: "Any bank as defined in section 3(a)(2) of the [Securities] Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;"

"Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;"

"Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;"

"Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in 230.506(b)(2)(ii); and"

"Any entity in which all of the equity owners are accredited investors."

For further discussion of the definition of accredited investor, see Securities Act Release No. 6825 (March 20, 1989), 54 FR 11369.

[100] In contrast to Rule 15c2–6, Rule 15g–1 would not exempt penny stock transactions in which the customer is: "Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;"

"Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000; or"

"Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year."

17 CFR 230.501(a)(4), (5), and (6).

However, an entity in which all of the equity owners are accredited investors, including any of the foregoing individual accredited investors, would be considered an exempt customer under Rule 15g–1. See 17 CFR 230.501(8).

[101] See, *e.g.*, *Hanly* v. *SEC*, 415 F.2d 589 (2nd Cir. 1969); and *SEC* v. *Great Lakes Equities Co.*, [Current] Fed. Sec. L. Rep. (CCH) ¶95,685, 98,206–7 (E.D. Mich. 1990), in which the court noted that: "[w]hen a company's securities are traded in the over-the-counter (OTC) market, the purchaser cannot easily verify the information provided by the registered representative. Therefore, the representative is under a special duty not to take advantage of the purchaser's lack of knowledge and must accurately represent his knowledge regarding the security. The sophistication of the customer as well as the amount of money lost by the customer are irrelevant factors in determining whether a violation by the broker or salesman has occurred."

[102] See discussion of proposed Rules 15g–2 through 15g–6, T3infra.T1 at sections III.D.—III.I. of this release.

[103] This exemption is similar to the exemption adopted in Rule 15c2–6. For a general discussion of "recommended" transactions, see 54 FR at 35477.

[104] In many states, the corporation's business plan must take into account corporation statutes that impose restraints on the repurchase of securities for the protection of shareholders and creditors. Delaware, for instance, prohibits the repurchase of common stock if it would impair capital. Del. Code Ann. tit. 8, § 160 (1983).

be required to purchase the securities of shareholders who exercise their appraisal rights. In addition, corporate issuers generally have access to information about the market for their own securities. Therefore, based on these considerations, the Commission believes that transactions in which the issuer of the penny stock is the purchaser of that stock should be exempt from proposed Rules 15g–2 through 15g–6.[105]

6. Exchange-Listed and NASDAQ Securities

In addition, paragraph (b) of Rule 15g–1 generally would exempt from Rules 15g–2, 15g–3, and 15g–6 any transaction in a penny stock that is registered, or approved for registration upon notice of issuance, on a national securities exchange that makes transaction reports available pursuant to Rule 11Aa3–1,[106] or that is authorized, or approved for authorization upon notice of issuance, for quotation on NASDAQ.[107] As proposed, Rules 15g–3 and 15g–6 would provide investors with market information that is relevant to their transactions in penny stocks, such as bid and offer prices, the number of shares to which these prices apply, and monthly statements of market value. Transactions in visible public markets, however, already provide such information to investors; that is, bid and ask quotations for penny stocks listed and traded on a national securities exchange are published by the exchange, and quotations for securities quoted on NASDAQ are entered into NASDAQ by market makers in the penny stock. Investors therefore have the ability to evaluate and monitor the market price of their penny stocks without having to rely exclusively on the representations of their broker-dealer. Furthermore, SRO rules impose certain restrictions on these quotations designed to protect investors. For example, under NASD rules, a market maker in a security is required to enter and maintain firm quotations that are reasonably related to the prevailing market price. The NASD has the authority to require a market maker to re-enter its quotations if it appears that they are no longer reasonably related to the prevailing market.[108]

The Commission believes that the availability of quotations and the protections of the SRO rules provide an adequate substitute for the disclosure requirements of proposed Rules 15g–3 and 15g–6. Accordingly, transactions in exchange-listed and NASDAQ securities would be exempt from Rules 15g–3 and 15g–6. In addition, in order to facilitate the initial execution of trades conducted through the facilities of an exchange or quoted on NASDAQ, Rule 15g–1(b) would exempt transactions in exchange-listed and NASDAQ securities from Rule 15g–2, which requires broker-dealers to provide customers with a risk disclosure document prior to effecting a trade in a penny stock.[109]

Transactions in a penny stock registered on a national securities exchange or quoted on NASDAQ, however, still would be subject to the requirements of proposed Rules 15g–4 and 15g–5.[110] Although the availability of price and volume information in these markets enhances the ability of investors to investigate the accuracy of their broker-dealer or salesperson's representations, it does not provide investors with comparable information regarding the broker-dealer's mark-ups or salesperson's compensation. For example, because market makers in a dominated market must calculate mark-ups on the basis of actual transactions, and not quotations, an investor may not be able to calculate the amount of remuneration that the broker-dealer will receive in a transaction from the quoted bid or offer price.[111] Furthermore, while Rule 10b–10 under the Exchange Act [112] currently requires a broker-dealer acting as an agent in a transaction to disclose in the confirmation of the transaction the amount of remuneration it received or that it will receive from the customer, the rule does not require the same disclosure with respect to principal transactions in non-reported securities. Rules 15g–4 and 15g–5 would supply this information by requiring broker-dealers to disclose the amount of compensation they receive in connection with any transaction in a penny stock (*i.e.*, a low-priced non-reported security),[113] as well as additional information regarding compensation paid to any associated person of the broker-dealer that has communicated with the customer with respect to that particular transaction. The Commission believes that, regardless of the market in which the penny stocks are traded, this information is relevant to an investor's decision to purchase or sell a penny stock. Thus, the proposed rule would provide an exemption only from Rules 15g–2, 15g–3, and 15g–6.

The exemption in paragraph (b) of Rule 15g–1 is further limited to penny stock transactions that are actually executed on a national securities exchange that makes transaction reports available pursuant to 17 CFR 240.11Aa3–1, or that are executed in NASDAQ securities with or by: (1) A dealer that is registered as a NASDAQ market maker in the penny stock that is the subject of the transaction, (2) a broker that is crossing two customer orders as agent, or (3) an underwriter or any member of a selling group that is participating in a distribution of the penny stock that is the subject of the transaction.

The exemption for exchange-listed and NASDAQ securities is premised on the availability of reliable quotation information resulting from full participation in those markets. Experience with Rule 15c2–6 has shown,

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[105] Transactions involving the shareholder selling the penny stock, however, would not be exempt under this provision.

[106] 17 CFR 240.11Aa3–1. Exchanges that currently qualify for this exemption are the NYSE, the Amex, the Boston Stock Exchange, the Cincinnati Stock Exchange, the Midwest Stock Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange, and the CBOE, which was authorized to provide transaction reports for equity securities other than options in Securities Exchange Act Release No. 28808 (January 22, 1991), 56 FR 3124.

[107] Schedule D to the NASD's by-laws provides that a new issue offered on a firm commitment basis will be considered for inclusion in the NASDAQ system when the registration statement is declared effective by the Commission or other appropriate regulatory authority. Accordingly, if prior contingent approval has been received from the NASD, securities that are offered on a firm commitment basis will be considered to be "approved for authorization upon notice of issuance" in the NASDAQ system under Rule 15g–1(b) at the time the registration statement becomes effective, provided that the NASDAQ financial authorization criteria are satisfied at that time. A new issue offered on a best efforts basis, however, will be considered for inclusion under the NASD rules only upon the closing of the offering if the issuer is relying on the proceeds of the offering to satisfy the NASDAQ financial authorization criteria. Thus, securities underwritten on a best efforts or contingency basis will not be considered to be "approved for authorization upon notice of issuance" in the NASDAQ system if NASD approval is contingent in whole or in part upon the amount of proceeds raised by the offering. See NASD Schedules to the By-Laws, Schedule D, pt. II § 1, NASD Manual (CCH) ¶ 1803 (1990); and letter from Robert L.D. Colby, Chief Counsel, Division of Market Regulation, SEC, to Thomas Boyle, Esq., Krys, Boyle, Golz, Reich & Freedman (May 7, 1990) (Rechargeable Battery Corporation).

[108] NASD Schedules to the By-Laws, Schedule D, pt. VI, § 2 NASD Manual (CCH) ¶ 1818 (1990). See also NYSE Rules, Rules 60–62, NYSE Guide (CCH) ¶¶ 2060–2062.

[109] See discussion, *infra*, at sections III.D.—III.I. of this release.

[110] These transactions also would be subject to the requirements of proposed Rule 15g–7. See discussion, *infra*, at section III.C.8. of this release.

[111] See *Alstead, Strangis & Dempsey, Inc.*, 47 S.E.C. 1034 (1984), discussed *infra*, at section III.F. of this release.

[112] 17 CFR 240.10b–10(a)(7).

[113] Because transactions in exchange-listed penny stocks that are executed on an exchange are usually conducted on an agency basis, in most cases, Rule 15g–4 will not impose any additional disclosure obligations on broker-dealers beyond those already required by Rule 10b–10(a)(7). For further discussion of Rule 10b–10, see *infra*, at section III.F. of this release.

however, that some listed securities have been primarily traded in the non-NASDAQ OTC market by market makers availing themselves of the Rule 15c2–6 exclusion for exchange-listed securities.[114] Furthermore, it appears that in the NASDAQ market not all active market makers in NASDAQ penny stocks have been willing to enter quotes in NASDAQ for those securities, thereby depriving investors of firm quotations and other market information.[115] As the House Report stated:

> The Committee is aware that certain securities that should properly be categorized as penny stocks may be able to gain registration on regional exchanges. Once registered on an exchange, most of the trading activity in these securities may be directed to the non-NASDAQ over-the-counter market, where a lack of trading or quotation information, higher spreads and markups, and other factors may operate to the disadvantage of public investors. Similarly, the fact that a security is authorized for quotation on NASDAQ would not preclude a market maker in the security from effecting transactions in the security without entering quotations in NASDAQ. Therefore, if exchange registration or NASDAQ authorization provided a complete exemption from the penny stock definition, investors effecting transactions in these securities with dealers in the non-NASDAQ over-the-counter market could be disadvantaged.[116]

Consequently, the Commission is proposing to limit the exemption for exchange-listed securities to trades that are actually effected on an exchange, and to restrict the exemption for NASDAQ securities to agency cross transactions and transactions involving a NASDAQ market maker or an underwriter in an offering. By restricting the exemption to these specific transactions, Rule 15g–1(b) attempts to provide investors with the benefits of the disclosure rules where market information is not otherwise provided by current exchange or comprehensive NASDAQ quotations.

7. Exemptive Authority

Finally, the Commission would retain the authority to exempt any transaction or persons or class of persons from Rules 15g–2 through 15g–6 if the Commission determines that an exemption would be consistent with the public interest and the protection of investors.

8. Rule 15g–7

At this time, the Commission is not proposing to exempt any transactions from the requirements of proposed Rule 15g–7. Paragraph (a) of proposed Rule 15g–7 generally would require a broker-dealer to disclose when it (or its affiliate) is acting as the sole market maker with respect to a particular penny stock.[117] The Commission preliminarily believes that this information is relevant to all low-priced non-reported securities that fall within the definition of penny stock. An investor cannot make a truly informed investment decision regarding a penny stock without being aware that the broker-dealer selling the security or an affiliated broker-dealer is a sole market maker with respect to that security, and as such, exercises substantial influence over the market for the security.[118] In any case, paragraph (a) of the proposed rule would apply only to situations in which the broker-dealer is acting as a sole market maker in the penny stock that is the subject of the transaction (unless it is acting as a specialist on a national securities exchange). Paragraph (c) of the proposed rule, as discussed below, merely prohibits market makers and their affiliates from making unwarranted representations regarding the market price of a penny stock. The proposed rule therefore would not impose any requirements on broker-dealers beyond those already required by established principles of fair dealing.[119] Accordingly, as proposed, Rule 15g–7 generally would apply to all non-reported securities priced below five dollars. The Commission, however, requests comment on whether the rule should apply to transactions in which the customer is an institutional accredited investor, or whether proposed Rule 15g–1 should be amended to exempt those transactions from the requirements of Rule 15g–7.

9. Request for Comment

The Commission requests comment on whether the scope of the definition of penny stock and the coverage of proposed Rules 15g–2 through 15g–7 is appropriate. In that connection, the Commission seeks comment on whether proposed Rule 3a51–1 should be further restricted and whether the exemptions in proposed Rule 15g–1 should be expanded in order to reduce the potential impact of the rules on capital formation. Commentators specifically are requested to address whether the $2,000,000 maintenance listing standard in paragraphs (e) and (f) of Rule 3a51–1 should be lowered, or whether a different standard would more accurately reflect the purpose of the rule, as discussed above. In addition, comment is requested on whether individual accredited investors should be exempt from the proposed disclosure rules.

Conversely, the Commission solicits comment on whether any of the exclusions from the definition of penny stock or the exemptions provided in proposed Rule 15g–1 would provide an opportunity for unscrupulous broker-dealers to circumvent the disclosure requirements of Rules 15g–2 through 15g–6, or for persons with a disciplinary history to become involved, as promoters or other associated persons of a broker-dealer or issuer, in offerings of "penny stock." The Commission especially seeks comment on whether, in view of the general lack of accurate information regarding thinly-traded penny stocks, institutional accredited investors and individuals who seek to purchase or sell penny stocks on their own initiative would benefit from the additional disclosure provided by proposed Rules 15g–2 through 15g–6. Finally, the Commission requests

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[114] 17 CFR 240.15c2–6(d)(2)(i).

[115] In recognition of this problem, the NASD has proposed to amend Schedule H to its by-laws to encompass NASDAQ and regional exchange-listed securities that are primarily traded in the OTC market within the reporting requirements of Schedule H. Schedule H requires reporting of price and volume for principal transactions in "non-NASDAQ" securities, provided that certain conditions are met. A "non-NASDAQ security" currently is defined under section 1(a) of Schedule H as "any equity security that is neither included in the National Association of Securities Dealers Automated Quotations System nor traded on any national securities exchange." NASD Schedules to the By-Laws, Schedule H, § 1, NASD Manual (CCH) ¶ 1932 (1990). The NASD proposal expands the definition of "non-NASDAQ security" to include OTC transactions in securities listed on a regional exchange that do not meet primary exchange listing requirements, as well as OTC trades in NASDAQ securities by persons not registered as NASDAQ market makers in such securities. Securities Exchange Act Release Nos. 28788 (January 16, 1991), 56 FR 2789, 28932 (March 1, 1991), 56 FR 9991.

[116] House Report 27.

[117] For further discussion of Rule 15g–7, see *infra*, at section III.J. of this release.

[118] An investor should be aware, for example, that it is difficult to resell a penny stock in a market that is dominated by a single market maker.

[119] For instance, Rule 15c1–8, 17 CFR 240.15c1–8, generally prohibits a broker-dealer that is participating in a primary or secondary distribution of a security that is not traded on a national securities exchange from representing that the security is being offered at the market price, unless it has grounds for believing that a market for such security exists outside of the market created or controlled by the broker-dealer. In addition, as a general rule, a broker-dealer is obligated under the antifraud provisions of the Exchange Act to disclose when it is acting as a market maker in a security that is the subject of the transaction. See also *Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167, 1172 (2d Cir. 1970) (failure of broker-dealer to inform customer of possible conflict of interest due to the fact that broker-dealer was acting as a market maker in the securities that it recommended to the customer constituted an omission of material fact in violation of Rule 10b–5 under the Exchange Act).

comment on whether these rules should apply to all penny stocks (as defined in Rule 3a51–1), regardless of whether the issuer of the securities meets the financial standards set out in Rule 15g–1(a)(2).

D. Rule 15g–2: Penny Stock Risk Disclosure Document

1. Background

Section 15(g)(2) of the Exchange Act requires a broker-dealer to provide to each of its customers, prior to effecting any transaction in any penny stock, a document that discloses the risks of investing in the penny stock market. The statute enumerates the specific types of information that must be included in the disclosure document, namely: (a) A description of the nature and level of risk in investing in the penny stock market, both for public offerings and secondary trading; (b) a description of the broker-dealer's duties to the customer and the rights and remedies available to the customer when those duties are not upheld and when there are violations of the federal securities laws; (c) a brief, clear, narrative description of the dealer market, including a discussion of bid and ask prices, and the significance of the spread between the bid and ask prices; (d) a toll-free telephone number for inquiries on disciplinary actions of broker-dealers and their associated persons; (e) definitions of significant terms used in the document or in the conduct of trading penny stocks; and (f) other information that the Commission requires by rule. The statute also grants the Commission specific rule-making authority with respect to the language to be used in the risk disclosure document and with respect to the type-face and format of the document. [120]

In the past, broker-dealers conducting high-pressure sales of penny stocks have tended to provide customers with little or no reliable information about the penny stock market. Even if an investor can obtain information about the issuer of the securities being purchased through a prospectus, that investor may not have information about the market in the security being purchased. For example, the investor may not be aware that there is a limited market for the security and that the bid price is substantially below the price at which the customer purchased the security. Accordingly, unless the security were to increase substantially in price, it could only be sold at a substantial loss, or not at all, once purchased. The investor also may not be aware that the broker-dealer selling the securities is the only or primary market maker in the securities, and may be controlling the market.

In addition, many small investors in penny stocks are not sophisticated about the market in general. They may not understand the meaning or consequences of market domination, the function or purpose of bid-ask quotations, or the significance of a wide spread between these quotes. Yet such investors, lacking knowledge of the market and the risks involved in investing, have been induced to invest a significant portion of their savings in penny stocks. [121]

Moreover, although a customer may receive some information about the security purchased in a confirmation issued pursuant to Rule 10b–10 under the Exchange Act, these disclosures usually are received after an investment decision and a commitment of money have been made. Were basic risk and market information disclosed before the transaction, the customer may decide not to invest at all in the security, or to limit the dollar amount of the investment.

The Commission has long recognized the need for enhanced disclosure with respect both to issuers and the markets. Significant strides have been made, for example, with respect to disclosures in registration statements, required filings, and prospectuses by issuers of low-priced or speculative securities. [122] Moreover, general market information has become increasingly accessible, particularly with the advent of automated quotation systems and real-time reporting of transactions for a wide variety of securities. However, unlike issuer disclosures, basic information about the nature of the market for penny stocks, its depth and liquidity, and the risks of investing, is still not available as a matter of course to investors. In most cases, investors must simply rely on quotations provided by a broker-dealer. [123] This lack of active, current disclosure, particularly of the investment risks involved, has contributed to the persistence of fraud and abuse in the market for low-priced securities. The Commission preliminarily believes that enhanced market-related disclosures to investors, as required by the Penny Stock Act, would complement issuer-specific prospectus disclosures and would be another useful tool to combat penny stock fraud.

In accordance with section 15(g)(2) of the Exchange Act, the Commission is proposing for comment Rule 15g–2, which would require broker-dealers to distribute to customers, prior to a transaction in penny stocks, a brief, standardized document that identifies certain of the risks of investing in low-priced securities and explains basic concepts associated with the market for penny stocks. The proposed rule would make it unlawful for a broker or dealer to effect a transaction with or for the account of a customer unless the disclosure document has been furnished previously to the customer.

In practice, the broker-dealer probably would send the disclosure document to a potential customer through the mail after preliminary telephone contact; however, the document also could be provided to a potential investor in the course of a meeting, before the investor agrees to the penny stock trade. In any event, a broker-dealer would be obligated to ensure that each customer has received the document before effecting the first transaction in penny stocks with the customer. [124]

[120] See section 15(g)(2)(F) of the Exchange Act.

[121] See, e.g., 1989 Hearings at 249–51 (statement of William and Lily Lynes, who testified that they lost $13,000 through the inducements of a penny stock salesman, stating, "We were basically unsophisticated, inexperienced investors when we opened our accounts with Stuart-James * * *. We had no idea that there were any special risks associated with buying these 'penny' stocks that did not apply to most all other stocks as well * * *"). Also, see generally Rule 15c2–6 Adoption Release and the 1983 Hearing.

[122] In testimony before Congress, for example, former Chairman Shad discussed improvements in issuer risk disclosure with respect to speculative securities. He cited as an example typical issuer disclosure of risk factors in a Form S–18 filed with the Commission in 1983: "The Company has been recently organized, has not yet commenced commercial activities, has no revenue, earnings or operating history and is dependent upon the net proceeds of this offering in order to commence commercial operations." The registration statement for the company also stated: "The company currently has no full-time employees and even upon completion of this offering none of its four officers and directors will be devoting a significant portion of their time to the Company's day-to-day activities and affairs * * *. Accordingly, while the Company will attempt to solicit business through its officers and directors for its proposed endeavors, there can be no assurance as to the volume of business, if any, which the Company may succeed in obtaining, or that its proposed operations will prove to be profitable." 1983 Hearing at 17. See also *Report of the Securities and Exchange Commission Concerning the Hot Issues Markets* (1984) at 41–45 ("* * * obtaining adequate disclosure in prospectuses generally has not been a problem in connection with the hot issues markets. However, the extent to which disclosure documents are made available to investors and are considered by them in connection with the purchase of securities is an area of continuing concern." *Id.* at 45).

[123] Some quotations are available in the pink sheets or the OTC Bulletin Board.

[124] As described in section III.H., "effecting" in this context means at the time of agreement, oral or otherwise, to the terms of the transaction.

The actual text of the document is set forth in a schedule to the rule, Schedule 15G, entitled the "Penny Stock Disclosure Document." The document presents information required by each of the categories set forth in section 15(g)(2) of the Exchange Act. The document is designed to be brief and to catch the attention of readers by highlighting issues that demand investor caution and by explaining in short, simple paragraphs the nature of the market and the risks involved. The schedule also contains specific instructions, as detailed below, for reproduction by individual broker-dealers.

The document is divided into three parts The first part ("Risk Disclosure Section") informs investors that all of the disclosures made in the document are required by the Commission; provides a non-technical definition of "penny stock," based on the definition provided in section 3(a)(51) of the Act and proposed Rule 3a51–1; and identifies certain of the risks of investing in penny stocks.[125] The Risk Disclosure Section cautions against making a hurried investment decision and discusses the often speculative nature of penny stocks, the potential for significant losses, and the possibility that an issuer promoted in this market may have few assets and few prospects for business success. These cautionary comments were derived from earlier Commission materials concerning penny stocks,[126] and from the previous suggestions of individuals and organizations.[127]

Pursuant to paragraph 15(g)(2)(D) of the Act, the Risk Disclosure part of the document also will provide a toll-free telephone number operated by the NASD, so that investors can obtain information about the background and disciplinary history of the broker-dealers with whom they are dealing.[128] The NASD is in the process of establishing the toll-free number, in accordance with the terms of the Section 509 of the Penny Stock Act.

Finally, included in the first part of the document is a statement that the Commission has not approved or disapproved the securities being sold or offered for sale, and has not passed upon the fairness or merits of the transaction or the accuracy or adequacy of the information contained in any prospectus or provided by a broker-dealer.[129]

The second part of the document (the "Customer Rights Section") informs investors about their rights under the new penny stock rules, and explains in a non-technical manner the broker-dealer's duties, including the particular disclosures that must be made to them under each of the new penny stock rules.[130] The Customer Rights Section also informs the customer of the timing requirements for the disclosures to them under the proposed rules.

In addition, the Customer Rights Section discusses remedies available to customers who have been sold penny stocks in an unfair manner or in violation of the federal securities laws. The paragraph informs customers in a general way of their potential rights under section 29(b) of the Exchange Act, as amended by the Penny Stock Reform Act, which may allow a rescission of the purchase contract for broker-dealer transactions in violation, *inter alia*, of the rules under new section 15(g) of the Exchange Act. It informs customers of the availability of private litigation if they believe they have been defrauded or their rights otherwise have been violated, and the use of arbitration procedures, if such an agreement has been signed. It informs investors that they also can report their grievances to regulatory authorities, including the Commission, the NASD, and their state securities administrator.

The third part of the document ("Market Information Section") provides consumers with basic, topical information about the market for low-priced securities.[131] It begins with a general description of the non-NASDAQ market and an explanation of important concepts associated with that market, such as the role of brokers and dealers, the tendency of investors to rely heavily on a broker-dealer for information about low-priced securities, and the importance of learning about both the broker-dealer and the security before making a purchase of penny stocks. The next section describes the dealer market

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[125] Pursuant to sections 15(g)(2) (A) and (E) of the Exchange Act.

[126] See, e.g., U.S. Securities and Exchange Commission, *The New Penny Stock Cold Calling Rule, Information for Investors* (Dec. 1989), *Penny Stock Telephone Fraud, Information for Investors* (June 1989), and *Beware of Penny Stock Fraud! Information for Investors* (Nov. 1988) (collectively, "*Penny Stock Brochures*"). These brochures have been made available to investors through various means. Unlike the proposed risk disclosure document, these documents are not required to be distributed to customers before investing in penny stocks. See also, remarks of David S. Ruder, Chairman, U.S. Securities and Exchange Commission, Before the Twenty-First Annual Rocky Mountain State-Federal-Provincial Securities Conference, Denver, Colorado, Penny Stock Manipulation and the Small Investor, 14–15 (October 21, 1988) ("Ruder Remarks"); and 1983 Hearing at 30–32 (statement of John Shad, Chairman, and John Fedders, Director of the Division of Enforcement, Securities and Exchange Commission).

[127] See, e.g., NASAA Report at 80–83, and 1989 Hearings at 136–37 (statement of John Baldwin, President, NASAA). In Congressional testimony and its report, NASAA called for a risk disclosure document that contained at least the following: "an explanation that investment in penny stocks entails a high level of risk and that such investment should not be undertaken by any investor who is unprepared to accept the possible loss of all invested capital; a description of the risk factors unique to penny stocks in both initial public offerings and secondary trading; an explanation that when there are not at least three independent market makers for a stock, no reliable market exists; and a brief, clear description of the 'bid' and 'ask' method of market maker quotes for penny stocks and an explanation that price information on the penny stock may be available only through the brokers who are market makers in the stock." NASAA also suggested, *inter alia*, that broker-dealers be required to disclose their disciplinary history before opening a customer account. NASAA noted that such risk disclosure would be in line with the type of disclosure required for options trading. See Options Clearing Corporation, *Characteristics and Risks of Standardized Options* (1987).

See also, comment letters on proposed Rule 15c2–6, including letter from Robert Abrams, Attorney General, State of New York, to Jonathan Katz (May 18, 1989) (presenting specific suggestions for risk disclosures); letter from Robert M. Lam, Chairman, Pennsylvania Securities Commission, to Jonathan Katz (April 19, 1989); letter from James H. Cheek III and Sam Scott Miller, on behalf of the American Bar Association, Section on Corporation, Banking and Business Law, to Jonathan Katz (April 25, 1989) (calling for a standardized booklet describing pink sheet securities); letter from Hugh H. Makens, Warner, Norcross & Judd, to Jonathan Katz (April 12, 1989) (calling for a standardized disclosure document similar to the booklet available for options); letter from King Ranier, on behalf of Beaconsfield Securities, Inc., to Lynn Nellius, Corporate Secretary, NASD (March 7, 1989) (arguing that customers should sign a letter acknowledging awareness of certain risks associated with investing in penny stock). These letters are included in Commission File No. S7–3–89.

See also, 1990 Hearing at 129–30 (statement of Dee Benson, U.S. Attorney, Utah); 1989 Hearings at 43–45 (statement of Laurie Skillman, Securities Administrator, Oregon Department of Insurance and Finance); and 1983 Hearing at 48–49 (statement of Senator Alfonse D'Amato).

[128] In addition to the requirements under the new section 15(g)(2)(D) of the Exchange Act, Section 509 of the Penny Stock Act amends section 15A of the Exchange Act by requiring the NASD, within a year, to "establish and maintain a toll-free telephone listing to receive inquiries regarding disciplinary actions involving its members and their associated persons." Also pursuant to this section the NASD must respond promptly to such requests in writing and may charge persons other than individual investors reasonable fees for the written responses. The statute states, however, that the NASD will not have liability to any person for actions taken or omitted in good faith under this provision of the Act.

[129] Pursuant to section 15(g)(2)(F) of the Exchange Act. This proposed statement is similar to notices required by Rule 13e–3 under the Exchange Act (17 CFR 240.13e–3(e)(3)(ii) (A) and (B)), Item 431 of Regulation C under the Securities Act (17 CFR 230.481(b)(1)), and Item 501 of Regulation S–K under the Securities Act (17 CFR 229.501(c)(5)). See also, *e.g.*, Regulation A, 17 CFR 230.610a, Item 1, part (e), and Division I, Item 2, of Schedules A, B, C and D to Regulation B, 17 CFR 230.300–346.

[130] See sections 15(g)(2) (B) and (E) of the Exchange Act.

[131] This section reflects sections 15(g)(2) (C) and (E) of the Exchange Act.

and explains the concept of market domination. It also warns of the risks associated with a dominated market, such as arbitrary and non-competitive pricing of securities and the inability to resell securities purchased under such conditions.

The subsequent paragraphs of the section describe the function and significance of dealer mark-ups and mark-downs, bid and offer prices, the spread between the bid and offer prices, and initial public offerings.[131a] Unlike the market descriptions in the Consumer Rights Section, which are geared to the particular penny stock rule being proposed, the explanations in this section are of general application and are designed to provide basic guidance for the least sophisticated of investors. For this reason, each paragraph also provides warnings about how a market function may be abused and result in investor losses.

Finally, the document provides the address and telephone number of the Consumer Services Office of the Commission and the headquarters of the NASD, both of which can provide consumers with further information about penny stocks, or direct them to other offices within the Commission or the NASD that may provide more particular guidance.

In addition to the actual disclosure document, Schedule 15G contains a detailed set of instructions for reproduction of the document by the broker-dealer. The instructions set forth, for example, the criteria for type size and type-face, so that the document reproduced will be uniform among broker-dealers, and so that the type will be sufficiently large to be legible to the average reader.[132] Because the disclosure document is in standardized language, the schedule can be reproduced by photographic copying, so long as the copy is clear, complete, and meets the minimum type size requirements set forth for a printed reproduction. In addition, the instructions prohibit the broker-dealer from adding to, omitting, or altering the language or format of the disclosure document in any way and prohibit the broker-dealer from charging customers a fee for receipt of the document.

2. Request for Comment

The purpose of the proposed rule is to provide potential investors with information about the market for and risks of investing in low-priced, non-NASDAQ, over-the-counter securities, as well as information concerning the specific low-priced security being recommended or sold to a person who intends to purchase or sell a penny stock. The Commission hereby solicits comments on the proposed rule and, in particular, whether the language of Schedule G accurately and concisely communicates the information required by the Act.

E. Rule 15g–3: Broker-dealer Disclosure of Quotations and Other Information Relating to the Penny Stock Market

1. Background

Paragraphs 15(g)(3)(A) (i) and (ii) of the Exchange Act require the Commission to adopt rules requiring a broker-dealer to disclose to each of its customers, prior to effecting any transaction in, and at the time of confirming any transaction with respect to any penny stock, the bid and ask prices for such penny stock, and the number of shares to which such bid and ask prices apply. If this information is not available, the broker-dealer must disclose other comparable information relating to the depth and liquidity of the market for the stock. The Exchange Act also gives the Commission authority to define the nature and parameters of the bid-offer disclosures.[133] In accordance with the statutory mandate, and in light of the specific interpretive guidance provided by the legislative history of the provision,[134] the Commission is proposing Rule 15g–3. This rule would require broker-dealers to disclose to customers, in the time-frames discussed above, quotations derived from interdealer bid and offer prices, based on the capacity in which a given sale or purchase is being effected, *i.e.*, as principal, agent, or riskless principal.

Such disclosures would give customers a better understanding of the market in penny stocks, particularly the fair value of the stock, whether the market for the stock is active or inactive, and whether they will be able to have their orders executed in a timely manner. Moreover, investors will clearly see the bid and offer side of the market in the stock. Such information should contribute significantly to the mix of material information that an investor needs in determining whether a particular investment is worthwhile.

In adopting the bid-ask provisions of the Penny Stock Act, the Committee expressed concern that, despite required disclosure of bid-offer information, investors still might not be informed of the true prevailing market price for a penny stock. The House Report stated:

> While the Committee believes that the disclosure of bid and ask quotations to customers will provide an additional source of useful information for customers to assess the relative merits of a particular investment, the Committee notes that quotations for such securities frequently are the subject of negotiation and may not accurately reflect the actual price a customer would pay or receive for the securities; in other words, they may not reflect accurately the "prevailing market price."[135]

Even prior to the Penny Stock Act, there was widespread testimony about abuses in the dissemination of bid-offer prices by penny stock dealers.[136]

[131a] In addition to the requirements of sections 15(g)(2) (C) and (E) of the Exchange Act, section 15(g)(2)(A) requires discussion in the disclosure document of the risks of investing in penny stocks during their initial public offerings.

[132] The fonts required by the Schedule are consistent with those used for other documents required to be produced under the Securities Act and Exchange Act. See, *e.g.*, the printing instructions set forth in Regulation S–K under the Securities Act, 17 CFR 229.501(c)(5), and Rule 13e–3 under the Exchange Act, 17 CFR 240.13e–3(e)(3)(ii) (A) and (B).

[133] In this respect, paragraph 15(g)(3)(A)(i) of the Exchange Act states that the broker-dealer disclosures must take place "in accordance with such procedures and methods as the Commission may require consistent with the public interest and the protection of investors."

[134] See House Report at 29–30.

[135] *Id.* at 29. See also, *e.g.*, *Charles Hughes & Co., Inc.* v. *SEC*, 139 F.2d 434 (2d Cir.), *cert. denied*, 321 U.S. 786 (1943) (a broker-dealer's obligation to deal fairly with its customers includes an implied representation that the price charged bears a reasonable relationship to the prevailing market price); *In re Trost & Co.*, 12 S.E.C. 531, 535 (1942) (broker-dealer charging "unreasonable prices" in individual transactions as a basis for fraud); and *Ryan* v. *SEC*, Sec. Reg. & L. Rep. (BNA) No. 26, 1273 (July 1, 1983) (9th Cir. 1983), aff'g, *In re James E. Ryan*, 47 S.E.C. 759 (1982), (broker-dealer pricing that is "substantially different" from the prevailing market price, without disclosure of such, as a basis for fraud under Section 10(b) of the Exchange Act). For a discussion of the determination of prevailing market price, see the section of this Release pertaining to proposed Rule 15g–4 (broker-dealer compensation).

[136] See, *e.g.*, NASAA Report at 25 ("In the wake of the creation of the NASDAQ system in 1971, price information on many OTC stocks now appears in all major newspapers, allowing investors to track bid and ask quotations. However, this same information is almost entirely unavailable for pink sheet penny stocks, leaving the unwary investor at the mercy of whatever quotes are supplied by the broker-dealer, who * * * may be the only market maker trading in the stock."). The Report also states, "Manipulation of the spread between bid and ask prices also is commonplace in the penny stock market. Brokers often refuse to trade at the prices quoted in the pink sheets. Spreads often are extremely wide and appear to have little relation to rational factors, such as supply and demand, cost, and the level of risk. A number of instances have been reported in which customers of the same branch office have been provided over a matter of minutes and hours substantially different spread quotations." Id. at 39. See *also*, Statement of Joseph Goldstein, mentioning as a problem in the penny stock market "grossly inflated price spreads and sales prices that include undisclosed excessive mark-ups," and "the dumping of securities at inflated prices by the promoters or brokers who

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Individuals and organizations also urged Congress and the Commission to adopt provisions requiring broker-dealer disclosure of fair and accurate bid-ask quotations.[137] The Commission seeks to address these concerns by proposing a rule that would require a broker-dealer to disclose its bid or offer quotations when validated by current interdealer purchases or sales at those quotations. If the quotations cannot be validated in this manner, the broker-dealer must disclose that there have not been interdealer purchases or sales of the penny stock at the quotation prices with any consistency in recent days. Moreover, the broker-dealer must disclose the actual prices at which the broker or dealer itself had purchased the security from, or sold the security to, another dealer.

2. Summary of Proposed Rule 15g–3

For the reasons outlined above, paragraph (a) of proposed Rule 15g–3 states that it shall be unlawful for a broker or a dealer to effect a transaction in any penny stock with or for the account of a customer unless such broker or dealer discloses to such customer, in the time periods and manner provided by the Rule, the following information. For transactions effected with or for the account of a customer on a principal basis, paragraphs (a)(1) (i) and (ii) require a dealer to disclose its own bid and offer prices if, during the previous five days, the dealer consistently has effected *bona fide* sales to, in the case of an offer quotation, or purchases from, in the case of a bid quotation, other dealers at its respective bid or offer price at the time of those transactions. In addition, the dealer must reasonably believe in good faith at the time of the transaction with the customer that its respective bid or offer price accurately reflects the price at which it is willing to sell to or buy from other dealers.

Where the dealer's own bid and offer prices differ from its interdealer transaction prices over the previous five days, paragraph (a)(1)(iii) requires the dealer to disclose that it has not consistently effected interdealer purchases or sales of the penny stock at its bid or offer price. The dealer also must disclose to the customer the price at which it last purchased the penny stock from, or sold the penny stock to, respectively, another dealer in a *bona fide* transaction.

In order for a broker-dealer to use its own quotations under the proposed rule, the broker-dealer must have effected interdealer purchases or sales *consistently* at the quoted price over the previous five-day period. The broker-dealer would be responsible for showing that at least seventy-five percent of its *bona fide* interdealer purchase or sales transactions over the previous five days had been effected at the respective bid or offer quotations; otherwise, the broker-dealer must make the disclosures required by paragraph (a)(1)(iii) of the proposed rule.

Moreover, in reviewing the quotations disseminated by dealers under the rule, the Commission would consider carefully the nature of the interdealer transactions used by a dealer to validate its bid and offer quotations to a customer, to determine whether the interdealer transactions are *bona fide*. The Commission believes it is necessary to monitor the legitimacy of such interdealer transactions because of its experience with patterns of pre-arranged or otherwise artificial trading in the penny stock market.

When operating under paragraph (a)(1)(iii) of the proposed rule, the dealer must present, in a clear manner, the required disclosures regarding its last transactions and its lack of interdealer activity. The Commission believes that under such circumstances it generally would be misleading to customers for dealers to provide, in addition, their own purported market quotations. If the dealer nonetheless chooses to provide additional quotations, such quotations must be *bona fide*, and the dealer must communicate clearly the nature of those quotations, without rendering the required disclosures ineffectual.[138]

In the case of a sole market maker in a penny stock, the terms of paragraphs (a)(1) (i) and (ii) would apply to disclosure of the market maker's quotations, so that the quotations provided to the customer would be based on a minimum level of market activity. In other instances where a dealer has not effected transactions consistently with other dealers over a five-day period, as, for example, in the first few days of an initial public offering, a dealer would be required to use paragraph (a)(1)(iii) of the proposed rule, and disclose to the customer that it has not effected previous, consistent interdealer purchases or sales. In the case of an initial public offering, the broker-dealer can, of course, explain that no trading market existed prior to the offering. This information should indicate to the customer that the market for the securities is inactive or untested, in that an interdealer market has not yet been established for the securities.

With respect to transactions effected by a broker on an agency basis, or by a broker-dealer on a riskless principal basis, paragraph (a)(2) of the proposed Rule requires a broker-dealer to disclose the best independent interdealer bid and offer prices for the penny stock that the broker-dealer obtains through reasonable diligence. The Commission believes that the "reasonable diligence" test would require the broker-dealer acting as agent or riskless principal, at a minimum, to follow standards set forth by the NASD, and generally accepted as industry practice, by presenting to the customer the best of three quotations obtained from independent dealers in the security.[139]

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then move on to the next manipulation as stock prices collapse." 1989 Hearings at 51. See also statement of Laurie Skillman, Securities Administrator, Oregon, before the same subcommittee, id. at 45, ("The current system of weekly 'pink sheets' listing of bid and ask prices allows for abuse. There is no regulatory mechanism set up * * * to easily make a determination about the fair market value of a stock because the information is not provided instantaneously. The spread between the bid and ask price is a key to market manipulation, [sic] however, this information is difficult and cumbersome to obtain."); 1990 Hearing at 123–25 (statement of Dee Benson, U.S. Attorney, Utah) (discussing the manner in which bid-offer prices are manipulated upward through trading in nominee accounts); and House Report at 20.

[137] See, *e.g.*, NASAA Report at 82 and statements of John C. Baldwin, President, NASAA, 1989 Hearings at 136, and Susan Bryant, President, NASAA, 1990 Hearing at 100–101; letter from Robert Lam, Chairman, Pennsylvania Securities Commission, to Jonathan Katz, Secretary, SEC (April 19, 1989); letter from Hugh H. Makens, Warner, Norcross & Judd, to Jonathan Katz (April 12, 1989); and submission from Dennis Palkon, Ph.D., Associate Professor, Florida Atlantic University, to Jonathan Katz (April 3, 1989). See also 1989 Hearings at 110 (statement of Lorenzo Formato, convicted for involvement in penny stock schemes backed by organized crime, endorsing better bid-ask disclosures).

[138] When making such additional quotations under paragraph (a)(1)(iii) of the proposed rule, the dealer must, at a minimum, communicate clearly to the customer that the dealer has not consistently effected such interdealer purchases or sales at its bid or offer for the number of shares to which the bid and offer apply and that the dealer's quotations under these conditions are potentially unreliable.

[139] These standards are consistent with a broker-dealer's obligations under the "shingle theory," particularly its obligation to obtain best execution for its customers' orders. See, *e.g.*, N. Wolfson, R. Phillips & T. Russo, *Regulation of Brokers, Dealers and Securities Markets*, 2.10 at 2–51 (1977); Securities Exchange Act Release No. 13662 (June 23, 1977), 42 FR 33520; and L. Loss, *Fundamentals of Securities Regulation* 828 (2d ed. 1988). In addition, *cf.*, 17 CFR 240.11Ac1–2(a)(15), defining "best bid" and "best offer" for quotations in a reported security. See also Interpretation of the Board of Governors, NASD Manual (CCH) ¶2151.03 (regarding the obligation of members to obtain dealer quotations in connection with the execution of orders in non-NASDAQ, OTC securities).

Finally, paragraph (a)(3) of the proposed Rule requires broker-dealers to disclose the number of shares to which the bid and offer prices apply. This provision is consistent with paragraph 15(g)(3)(A)(ii) of the Exchange Act. In accordance with industry practice, the disclosure of shares would be in terms of round lots (typically, groups of one-hundred shares). However, the broker-dealer must take care in conversations with the customer not to let the size of the nominal quotation (*e.g.*, a quotation for one-hundred shares) mislead the customer with respect to that customer's actual cost in a transaction when the number of shares being purchased or sold differs from the volume to which the quotation pertains.[140]

3. Request for Comment

The purpose of the Proposed Rule is to provide investors with bid and offer prices of penny stocks based on *bona fide* interdealer purchases and sales. Such disclosures are intended to display the prevailing market prices for a security and to discourage arbitrary or unfair pricing by dealers. The Commission hereby solicits comments on the proposed rule, both in terms of its value to investors and its potential operational ramifications for broker-dealers. The Commission in particular requests comments on the adequacy and appropriateness of paragraph (a)(1)(iv) of the proposed rule, which states that "consistently" shall constitute at least seventy-five percent of a dealer's purchase or sales transactions during the previous five-day period.

F. Rule 15g–4: Compensation of Brokers or Dealers

1. Introduction

The Penny Stock Act requires the Commission to adopt a rule requiring disclosure of broker-dealer compensation both prior to effecting any transaction in, and at the time of confirming any transaction with respect to, any penny stock.[141] Congress was concerned that customers in the penny stock market have little notion of the often high compensation that broker-dealers obtain in penny stock transactions.[142] Broker-dealers are not currently required to disclose their compensation in penny stock transactions except in agency and "riskless principal" trades,[143] whereas the penny stock market is primarily a dealer market.

Large, undisclosed mark-ups and mark-downs[144] have been a particular problem in the penny stock market.[145] This market is often dominated by a single dealer or market maker and is thus characterized by the absence of liquidity or price competition.[146] The potential for large mark-ups and mark-downs for penny stock dealers has given rise to the related problems of high pressure sales practices, market manipulation, and other forms of fraudulent conduct.[147] In the Penny Stock Act, Congress has sought to combat these various abuses in part by requiring disclosure of broker-dealer compensation.

Rule 15g–4 as proposed requires disclosure of compensation of broker-dealers both prior to effecting a transaction in a penny stock, and at the time of confirming the transaction.[148] The rule, which defines compensation separately in agency, riskless principal, and dealer transactions, would require disclosure of broker-dealer compensation to any customer, but excludes from the definition of customer any broker or dealer, as such terms are defined under the Exchange Act.[149]

2. Definition of Compensation

Proposed Rule 15g–4 separates compensation of broker-dealers into three categories. First, the rule would define the compensation of a broker-dealer that is engaged in an agency transaction in a penny stock for a customer as the amount of any remuneration received or to be received by it from the customer. Compensation in agency transactions generally consists of a commission. As noted previously, the amount of remuneration to be received from the customer in agency transactions currently must be disclosed to the customer on the confirmation pursuant to Rule 10b–10(a)(7)(ii)[150] under the Exchange Act, and Rule 10b–10's general standard is used for agency transactions in Rule 15g–4.[151] Second, Rule 15g–4 would

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[140] In this context, the Commission believes that the anti-fraud provisions of the federal securities laws would prohibit the dealer from providing a quotation for a round lot of shares without further explanation if the broker-dealer is aware that this quotation in fact misleads the customer with respect to the value actually paid or received by the customer in a transaction resulting from such a quotation.

[141] Section 15(g)(3)(A) reads, in relevant part: "(3) Commission Rules Relating to Disclosure.—The Commission shall adopt rules setting forth additional standards for the disclosure by brokers and dealers to customers of information concerning transactions in penny stocks. Such rules—(A) shall require brokers and dealers to disclose to each customer, prior to effecting any transaction in, and at the time of confirming any transaction with respect to any penny stock, in accordance with such procedures and methods as the Commission may require consistent with the public interest and the protection of investors * * * the amount and a description of any compensation that the broker or dealer and the associated person thereof will receive or has received in connection with such transaction." 15 U.S.C. 78*o*(g)(3)(A).

[142] The House Report on the Penny Stock Act stated, in relevant part: "Penny stock schemes usually include undisclosed excessive markups (essentially, the difference between the prevailing market price and the sale price to the customer) of as much as 1000 percent. Instead of making money on commissions as full-service brokerages do, penny stock firms make substantial profit on the markups they charge. For example, a full-service brokerage might expect to make an $85 commission on a $4,000 sale. By comparison, a penny stock dealer may buy 20,000 shares of a stock for $2,000, sell it for $3,000 (a 50 percent markup), and make $1,000 profit." House Report 12.

[143] See paragraphs (a)(7)(ii) and (a)(8)(i)(A) of the Commission's Rule 10b–10 under the Exchange Act. See discussion *infra*.

[144] When a dealer as principal sells a security to a customer, it will include, as compensation, a mark-up over the prevailing market price. Similarly, when a dealer purchases a security from a customer, it will calculate a mark-down from the prevailing market price and effect the transaction at that lower price. In this release, the terms "mark-ups" and "mark-downs" will sometimes be used in lieu of "compensation" for purposes of greater clarity, but "mark-ups" and "mark-downs" are included in the meaning of "compensation" as defined under proposed Rule 15g–4.

[145] See, *e.g.*, *Handley Investment Co.* v. *SEC*, 354 F.2d 64 (10th Cir. 1965); *SEC* v. *Great Lakes Equities Co.*, [current] Fed. Sec. L. Rep. (CCH) ¶ 95,685, at 98,201 (E.D. Mich. September 4, 1990); *Financial Estate Planning*, Securities Exchange Act Release No. 14984 (July 21, 1978), 15 SEC Doc. 352.

[146] See, *e.g.*, *Hoxworth* v. *Blinder Robinson & Co., Inc.*, 903 F.2d 186 (3rd Cir. 1990); *Dale R. Dargie*, Securities Exchange Act Release No. 28785 (January 18, 1991), 47 SEC Doc. 2225; *Joe M. County*, Securities Exchange Act Release No. 28555 (October 19, 1990), 47 SEC Doc. 1043.

[147] Such fraudulent practices have included churning of customer accounts, selling to nominee accounts to inflate the prices of securities, selling by insiders at inflated prices, and making promotional statements that bear little or no relationship to the actual situation of the issuer. See NASAA Report. See also *SEC* v. *Great Lakes Equities Co.*, [current] Fed. Sec. L. Rep. (CCH) ¶ 95,685, at 98,201 (E.D. Mich. September 4, 1990); *First Pittsburgh Securities Corp.*, Securities Exchange Act Release No. 16897 (June 16, 1980), 20 SEC Doc. 401; *Mark E. O'Leary*, 43 S.E.C. 842 (1968).

[148] The timing and procedure of disclosure are discussed at section III. H. of this release.

[149] 15 U.S.C. 78c(a) (4), (5).

[150] 17 CFR 240.10b–10(a)(7)(ii).

[151] See paragraph (c)(1)(i) of the proposed rule. A separate paragraph of Rule 10b–10, paragraph (a)(7)(iii), currently requires that the broker-dealer also inform the customer on the confirmation of the amount of remuneration received in connection with the trade from any other person, but generally allows the broker-dealer only to inform the customer whether such remuneration has been received and that the details are available on request. In a different context, the Midwest Stock Exchange, Inc. has petitioned the Commission to adopt rules to provide disclosure of the practice of "payment for order flow," which is prevalent in sections of the OTC market. Letter from J. Craig Long, Vice President, General Counsel and Secretary, Midwest Stock Exchange, to Jonathan Katz, Secretary, Securities and Exchange Commission (May 21, 1990). The NASD separately has submitted a rule filing to the Commission that would require NASD members to include further

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define compensation of a broker-dealer, including a market maker, that executes a "riskless principal" transaction in a penny stock as the difference between the price to the customer and the contemporaneous purchase or sale that is made in connection with such transaction. A riskless principal transaction is a transaction in which a broker-dealer, after receiving (or receiving the commitment for) a buy or sell order from its customer, makes a purchase or sale of the penny stock as principal from or to another person to offset the sale or purchase from or to such customer. Because riskless principal transactions do not involve holding securities in inventory for any appreciable length of time, the calculation of a broker-dealer's compensation in such transactions is relatively straightforward.[152]

Third, Rule 15g–4 would define compensation of a broker-dealer that executes principal transactions, other than riskless principal transactions, as the difference between the price to the customer charged by the dealer and the prevailing market price. Calculation of compensation in this third category of principal transactions, in which the broker-dealer purchases or sells for its own account, must account for the often illiquid or noncompetitive nature of the penny stock market. Through administrative and judicial proceedings, the Commission has maintained the long-standing position that undisclosed excessive mark-ups and mark-downs violate the antifraud provisions of the federal securities laws,[153] and has set forth the appropriate methods for calculating broker-dealer mark-ups. In addition, since 1943, the NASD has deemed it inconsistent with just and equitable principles of trade under its Rules of Fair Practice for a member to enter into any securities transaction with a customer at a price not reasonably related to the current price of the security.[154]

The Commission and the courts consistently have held in mark-up cases that, absent countervailing evidence, the prevailing market price is the price paid by a dealer in actual contemporaneous transactions with other dealers.[155] This standard, and a variation for certain dealer transactions, has been described most succinctly in the Commission's 1984 decision in *Alstead, Strangis & Dempsey, Inc. ("Alstead")*,[156] which Congress, in its House Report on the Penny Stock Act, endorsed as the "leading case" establishing the principles for calculating mark-ups.[157] The standards under *Alstead* as summarized in this release are intended to provide a framework for broker-dealers to use in calculating compensation when acting as principal in transactions in penny stocks. Broker-dealers are encouraged to refer to that case in conjunction with this release for a statement of the Commission's standards regarding calculation of compensation.

The Commission in *Alstead* first reiterated the general contemporaneous cost standard. In one of the situations presented by the case, several market makers in an equity security were listed in the "pink sheets," and the firm in question, Alstead, Dempsey & Co., also entered quotations in regional interdealer quotation sheets. Nonetheless, the Commission held that except for the prices Alstead, Dempsey & Co. charged another dealer in two transactions, the best evidence of prevailing market price was the price paid by Alstead, Dempsey & Co. in contemporaneous transactions, in view of the unreliability of Alstead, Dempsey & Co.'s offer quote.[158]

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explanation of their remuneration received in return for order flow. Securities Exchange Act Release No. 28020 (May 15, 1990), 55 FR 21284, as amended in Securities Exchange Act Release No. 28774 (January 14, 1991), 56 FR 2573. In view of the pendency of these initiatives, the Commission is not proposing at this time to require in Rule 15g–4 disclosure of additional compensation received from others. Nonetheless, the Commission requests comment whether this form of additional compensation should be covered by the rule.

[152] Rule 10b–10 requires broker-dealers, other than market makers, that execute riskless principal trades in equity securities to disclose the amount of any mark-up, mark-down, or similar remuneration received in the transaction. The Commission believes that Rule 15g–4 provides a clearer articulation of this requirement for riskless principal transactions and requests comment whether Rule 10b–10(a)(8)(i)(A) should be amended to conform to this language.

The determination whether a dealer makes a *bona fide* purchase or sale of penny stock that can properly be characterized as an off-setting riskless principal transaction, the compensation for which would thereby come within the definition of compensation for riskless trades under Rule 15g–4(d)(2), can only be established on a case-by-case basis.

[153] The Commission and the courts have stated for over 50 years that a broker-dealer, by holding itself out as a securities professional with special knowledge and ability, impliedly represents that it will deal fairly, honestly, and in accordance with industry standards with the public investor. "[A] dealer may not exploit the ignorance of his customer to extract unreasonable profits resulting from a price which bears no reasonable relation to the prevailing market price." *Duker* v. *Duker*, 6 S.E.C. 386, 389 (1939). Specifically, a broker-dealer impliedly represents that the prices it charges bear a reasonable relation to the prevailing market price, and any excessive mark-up is inconsistent with that implied representation. Under this theory, the courts have found violations of section 17(a) of the Securities Act, 15 U.S.C. 77q(a), and section 10(b) of the Exchange Act, 15 U.S.C. 78j(b), and Rule 10b–5 thereunder, 17 CFR 240.10b–5. See generally *Charles Hughes & Co.* v. *SEC*, 139 F.2d 434 (2d Cir.), *cert. denied*, 321 U.S. 786 (1943); *SEC* v. *Great Lakes Equities Co.*, [current] Fed. Sec. L. Rep. (CCH) ¶95,685, at 98,201 (E.D. Mich. September 4, 1990); *Trost & Co., Inc.*, 12 S.E.C. 531 (1942).

[154] Interpretation of the Board of Governors, NASD Manual (CCH) ¶2154, at 2056. The NASD generally will consider mark-ups and mark-downs on equity securities greater than five percent above the prevailing market price to be unfair or unreasonable. However, the determination of the fairness of mark-ups and mark-downs must be based on a consideration of all the relevant factors, of which the percentage is only one. *Id.* at 2055, 2057. See *Gerald M. Greenberg*, 40 S.E.C. 133, 136–37 (1960).

The Commission consistently has held that undisclosed mark-ups and mark-downs of more than ten percent are fraudulent in equity securities. See, *e.g., Peter J. Kisch*, 47 S.E.C. 802, 808 (1982); *Staten Securities Corp.*, 47 S.E.C. 766, 767 (1982); *Powell & Assocs.*, 47 S.E.C. 746, 748 (1982); *Charles Michael West*, 47 S.E.C. 39, 42 n.12 (1979). The Commission has applied the ten-percent standard in decisions involving the penny stock market as well. See *LSCO Securities, Inc.*, Securities Exchange Act Release No. 28994 (March 21, 1991), 48 SEC Doc. 759; *James E. Ryan*, Securities Exchange Act Release No. 18617 (April 5, 1982), 24 SEC Doc. 1859; *First Pittsburgh Securities Corp.*, Securities Exchange Act Release No. 16897 (June 16, 1980), 20 SEC Doc. 401; *Costello, Russotto & Co.*, 42 S.E.C. 798 (1965); *J.A. Winston & Co.*, 42 S.E.C. 62, 69 (1964).

In addition, both the Commission and the NASD have held that compensation below the stated percentages with respect to equity securities may be excessive under certain circumstances. See *Shearson, Hammill & Co.*, 42 S.E.C. 811, 837 (1965) (Commission found mark-ups of 5.4%, 5.7%, and 6.3% excessive); *Thill Securities Corp.*, 42 S.E.C. 89, 92–95 (1964) (mark-downs as low as 3.9% found to be inconsistent with NASD Rules of Fair Practice).

[155] See, *e.g., Barnett* v. *United States*, 319 F.2d 340, 344 (8th Cir. 1963). For Commission rulings, see, *e.g., First Pittsburgh Securities Corp.*, 47 S.E.C. 299, 306 (1980); *DMR Securities, Inc.*, 47 S.E.C. 180, 182 (1979); *Maryland Securities Co., Inc.*, 40 S.E.C. 443, 446 (1960); *Samuel B. Franklin & Co.*, 38 S.E.C. 908, 910 n.4, *aff'd, Samuel B. Franklin & Co.* v. *SEC*, 290 F.2d 719 (9th Cir.), *cert. denied*, 368 U.S. 889 (1961).

[156] 47 S.E.C. 1034 (1984). The Commission has applied the *Alstead* principles in decisions involving the debt securities markets. See, *e.g.*, Amicus Brief of the Securities and Exchange Commission, *Elysian Federal Savings Bank* v. *First Interregional Equity Corp.*, 713 F.Supp. 737 (D.N.J. 1989) [No. 88–3528], at 15 n.20, 20 n.27. In an interpretive statement concerning the zero-coupon market, the Commission stated that the best evidence of the prevailing market price would generally be the broker-dealer's contemporaneous retail purchase price, adjusted to reflect the mark-down inherent in such customer transactions. Securities Exchange Act Release No. 24368 (May 5, 1987), 52 FR 15575. Zero-coupon securities are often a proprietary product of a broker-dealer that is usually the sole market maker in the interdealer market, if there is one.

[157] House Report 30.

[158] *Alstead*, at 1038. The NASD's policy in determining prevailing market price in calculating mark-ups and mark-downs is in accord with this position. The NASD's interpretation of its mark-up policy, reads, in relevant part: "Since the adoption of the "5% Policy" the Board has determined that. The mark-up over the prevailing market price is the significant spread from the point of view of fairness of dealings with customers in principal transactions. In the absence of other bona fide evidence of the prevailing market, a member's own contemporaneous cost is the best indication of the prevailing market price of a security." Interpretation of the Board of Governors, NASD Manual (CCH) ¶ 2154, at 2056.

However, in *Alstead*,[159] and in other decisions,[160] the Commission modified the contemporaneous cost standard for certain principal trades in active and competitive markets. A dealer trading in such a market, that is acting as a market maker rather than effecting a riskless principal trade, would be able to use its own contemporaneous interdealer sales price or the sales prices of other dealers, if known, in actual transactions as the basis for computing mark-ups and mark-downs.[161] In the absence of actual, contemporaneous interdealer sales by the market maker or other dealers, the market maker's own lowest offer quote, or the lowest offer quote of other market makers, may be used as evidence of prevailing market price.[162] However, in order to use an offer quote, the reliability of the market maker's offer prices generally must be validated over time by comparing them with actual interdealer transactions. Although such transactions need not be contemporaneous, they would have to occur with some frequency, and consistently be effected at prices at or around the offer quotes.[163]

In the absence of both actual interdealer sales and validated offer quotes, the market maker's contemporaneous cost must be employed as a basis for the computation. Contemporaneous cost is based on the market maker's purchase that is closest in time prior to the transaction.[164]

In a market dominated by a market maker to such an extent that it controls wholesale prices for a security,[165] market makers are required to apply the contemporaneous cost standard in calculating mark-ups. Where a market maker dominates the trading market for a security, it may be free to control both the quotation spreads and the trading occurring in that market. As a result, neither the market maker's offer quotations or interdealer sales may be indicative of an independent prevailing market price. Accordingly, in those situations, a market maker must use its contemporaneous purchase price in transactions with other dealers as evidence of the prevailing market price in calculating mark-ups. In the absence of actual interdealer purchases, the market maker must use its contemporaneous purchase price from retail customers, adjusted for the mark-down to such customers.[166] This mark-down adjustment should not exceed the amount generally accepted under the NASD's mark-up rule.[167]

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[159] *Alstead*, at 1035–36.

[160] See, *e.g.*, *Peter J. Kisch*, 47 S.E.C. 802, 808–809 (1982); *General Investing Corp.*, 41 S.E.C. 952, 954–55 (1964).

[161] *Alstead*, at 1036; See also *LSCO Securities, Inc.*, Securities Exchange Act Release No. 28994 (March 21, 1991), 48 SEC Doc. 759 (NASD properly computed mark-ups in certain transactions on basis of price that the firm charged another dealer); *Peter J. Kisch*, 47 S.E.C. 802, 808 (1982) (market maker's own actual contemporaneous sales to other broker-dealers should be used in computing mark-ups); *Gateway Stock and Bond, Inc.*, 43 S.E.C. 191, 194 (1966) (evidence showed that contemporaneous prices at which NASD member effected sales constitute appropriate basis for computing mark-ups). Interdealer transactions should be reasonably related to the best available quotations (*i.e.*, highest bid and lowest offer) regardless of whether such quotations are the dealer's own. Memorandum of the Division of Market Regulation to the Commission, In the Matter of Alstead, Strangis & Dempsey Inc., Administrative Proceeding File No. 3–6135 (April 8, 1983) (hereinafter referred to as "Division Memorandum"), at 21 n.47.

[162] Quotations for NASDAQ securities that are actively traded, have narrow spreads, and have significant trading independent of the market maker in question are an example of acceptable quotations under the circumstances set forth in this release. Division Memorandum at 23.

However, the Commission cautions that offer quotes may be employed only in certain limited situations. The Commission stated in *Alstead*, in relevant part: "Where there is an active, independent market for a security, and the reliability of quoted offers can be tested by comparing them with actual inter-dealer transactions during the period in question, such quotations may provide a proper basis for computing markups. Thus, if inter-dealer sales occur with some frequency, and on the days when they occur they are consistently effected at prices at or around the quoted offers, it may properly be inferred that on other days such offers provide an accurate indication of the prevailing market." *Alstead*, at 1036–37.

"The Commission traditionally has believed that actual transactions are a more reliable indicator of the prevailing market price than quotations. *Id.* at 32. Offer quotes by OTC market makers generally are negotiable. In less active markets, market makers often purchase securities at prices higher than their bid and sell at prices lower than their offer quotes, which may even be higher than the best bid or lower than the best offer. *Id.* at 8. As the Commission further stated in *Alstead*, 'quotations for obscure securities with limited inter-dealer trading activity may have little value as evidence of the current market.' *Alstead*, at 1036. The Commission reaffirmed the lack of reliability of quotations for thinly traded securities most recently in *LSCO Securities, Inc.*, Securities Exchange Act Release No. 28994 (March 21, 1991), 48 SEC Doc. 759. *See also Gateway Stock and Bond, Inc.*, 43 S.E.C. 191, 193 (1966) ('[s]ince such offers were not generally tested in the market place by sales by the member to dealers or by other inter-dealer sales, they were not a reliable guide to market price.'); *C.A. Benson & Co., Inc.*, 42 S.E.C. 952, 954 (1966) (firms did not sell a single share to another dealer at inside offer; thus NASD properly disregarded offering price in sheets)."

[163] The Commission generally has required strong evidence that offer quotes accurately reflect prevailing market price because of the lack of reliability of quotations in the OTC market. See, *e.g.*, *Alstead*, at 1036–37; *Gateway Stock and Bond, Inc.*, 43 S.E.C. 191, 193 (1966); *Naftalin & Co., Inc.*, 41 S.E.C. 823, 826–28 (1964). Moreover, the Commission has long held that a broker-dealer in enforcement proceedings has the burden of bringing forth evidence that the use of contemporaneous cost is not appropriate for computing mark-ups or mark-downs. See *James E. Ryan*, Securities Exchange Act Release No. 18617 (April 5, 1982), 24 SEC Doc. 1859 (contemporaneous cost as best evidence of prevailing market price is rebuttable presumption). See also *Barnett* v. *United States*, 319 F.2d 340, 344 (8th Cir. 1963); *Powell & Assocs., Inc.*, 47 S.E.C. 746, 747 (1982) (burden is on dealer to establish that contemporaneous cost is not "true market price"); *First Pittsburgh Securities Corp.*, 47 S.E.C. 299, 306 (1980) (dealer had burden to show costs did not represent mark-up); *Charles Michael West*, 47 S.E.C. 39, 41–42 (1979) (dealer has burden to establish that contemporary cost is not reliable indicator of prevailing market price).

[164] The Commission believes that same day purchases are the best indication of contemporaneous cost. However, the Commission recently has held that, absent some showing of a change in the market, contemporaneous cost may be based on interdealer purchases for a period up to five business days prior to a particular transaction. See *LSCO Securities, Inc.*, Securities Exchange Act Release No. 28994 (March 21, 1991), 48 SEC Doc. 759. See also *First Pittsburgh Securities Corp.*, 47 S.E.C. 299, 306 (1980) (contemporaneous cost not limited to same-day cost but prices paid by dealer should be "closely related in time" to its retail sales); *Advanced Research Assocs., Inc.*, 41 SEC 579, 611–12 (1963) ("substantially contemporaneous" purchase prices are calculated during period with little fluctuation in purchase and sales prices). In cases of multiple purchases during the day of sale, contemporaneous cost is based on the purchase price closest in time to the sale. The average of prices during that day or any particular period of time cannot be used. See *Century Securities Co.*, 43 S.E.C. 371, 378 (1967), *aff'd sub nom, Nees* v. *SEC*, 414 F.2d 211 (9th Cir. 1969) (average cost is not appropriate evidence of market price).

[165] In *Alstead*, the Commission found that Alstead, Dempsey & Co. dominated the market in a particular security where it had been the underwriter of that security on a "best efforts" basis and sold 95.7% of the offering to its own customers. Alstead, Dempsey & Co. became a market maker in the security, and during the period at issue, its transactions with other dealers and customers amounted to more than 297,000 shares out of a total volume of 345,000 shares, or 86% of the volume. Alstead, Dempsey & Co. effectively controlled the supply of the security since most of it was held by the registrant's customers. Only two other dealers were market makers in the stock, and their combined transactions amounted to only 7,750 shares, 2.2% of the total trading volume. The Commission consequently used Alstead, Dempsey & Co.'s contemporaneous cost of the stock in computing mark-ups. *Alstead*, at 1037.

[166] For example, in a recent decision, the Commission affirmed the NASD's inference of a 7% mark-down from contemporaneous prices paid to customers in determining prevailing market price for purposes of calculating mark-ups. See *LSCO Securities, Inc.*, Securities Exchange Act Release No. 28994 (March 21, 1991), 48 SEC Doc. 759.

[167] The Commission wishes to emphasize that even when disclosure of compensation is properly made under Rule 15g–4, a broker-dealer remains subject to the general antifraud provisions of the federal securities laws.

The Commission cautions that even if it fully meets the materiality requirements of the antifraud provisions of the federal securities laws, an NASD member that charges substantial mark-ups could violate Article III, section 4 of the NASD Rules of Fair Practice, which requires NASD members to "buy or sell at a price which is fair," and could violate the NASD's mark-up policy adopted under that section. Article III, Section 4, NASD Manual, Rules of Fair Practice (CCH) ¶2154, at 2054. The NASD rules apply to virtually all penny stock broker-dealers. Pursuant to Section 15(b)(8) of the Exchange Act, all registered broker-dealers that effect securities transactions must be a member of a

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3 Request for Comment

The Commission requests comment on proposed Rule 15g–4. In particular, commenters are requested to address the rule's definition of compensation and this release's articulation of the appropriate manner of determining prevailing market price in the penny stock dealer market.

G. Rule 15g–5: Associated Person Compensation

1. Compensation of Salespersons in the Penny Stock Market

In the House Report, the Committee noted the large spreads and mark-ups that are often charged in connection with penny stock transactions.[168] Large interdealer spreads for penny stocks provide the potential for great profits from penny stock transactions, both to broker-dealer firms and their associated persons who initiate and maintain contacts with customers. Because of the connection between extraordinary sales agent compensation and fraudulent practices relating to penny stocks, Congress concluded that requiring disclosure of compensation paid to associated persons in connection with penny stock transactions would provide important information to investors in evaluating recommendations by salespersons and could thereby help to deter penny stock fraud.

The compensation that a salesperson may expect to receive from his or her firm in certain situations may influence the salesperson's decisions concerning the securities that he or she recommends, purchases, and sells.[169] The federal securities laws and the rules thereunder recognize the need for disclosure to customers of broker-dealer compensation arrangements in certain contexts. For example, Rule 10b–10 under the Exchange Act requires that trade confirmations provided in connection with agency transactions must disclose, in addition to the amount of remuneration to be received by the broker-dealer from the customer, information concerning remuneration to be received from any other party in connection with the transaction.[170] In addition, Rule 15c1–6 [171] requires that both brokers and dealers receiving advisory fees may not effect transactions for or with customers in any security in the primary or secondary distribution of which such brokers or dealers are participating or financially interested unless they provide notification of such participation or interest.[172] Presently, however, there are no rules under the federal securities laws expressly requiring disclosure of remuneration received by associated persons, as distinguished from broker-dealer firms.[173] In the context of the penny stock market, large interdealer spreads often permit associated persons to receive compensation that is extremely large in relation to the price of the securities purchased or sold.[174] The potential compensation that salespersons may receive from penny stock transactions frequently is much greater than that deriving from transactions in securities with more established and competitive markets.[175] This financial incentive creates a potential conflict with the duties of broker-dealers and their associated persons to recommend suitable investments for and otherwise deal fairly with their customers, in light of the fact that speculative penny stocks often are not suitable for persons who have limited financial means and cannot afford a substantial or total loss of their investments.

Requiring disclosure of the compensation paid to associated persons will enable investors and potential investors to make more informed investment decisions. The rule would not affect or otherwise limit the obligation of broker-dealers under the general antifraud provisions to disclose to customers compensation arrangements where warranted by particular facts and circumstances.[176]

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national securities association. Currently, the NASD is the only national securities association. Only registered broker-dealers that effect securities transactions as a member of, and solely on, a national securities exchange, are not required to be NASD members. 15 U.S.C. 78*o*(b)(8). See also Securities Exchange Act Release No. 24368 (May 5, 1987), 52 FR 15575, at 15576 n.8 (rules of just and equitable principles of trade prohibit mark-ups that are unfair in light of all other relevant circumstances, even if disclosed).

[168] House Report 12.

[169] In discussing the effect of compensation structures of broker-dealer firms on the motivation of salespersons, the Special Study stated that This [compensation] system tends to make personal economic considerations a factor in the salesman's selection of securities which he recommends to his customers. Since he usually earns more money on over-the-counter transactions than on exchange transactions of comparable size, the salesman has an economic incentive to emphasize the former type of security in his recommendations. Since he earns little or no commission on customers' sales of securities in the over-the-counter market, he has an economic incentive to advise a customer to sell only if the proceeds are needed or likely to be used for the purchase of other securities. Since the salesman's rate of compensation is highest when he sells securities being distributed by the firm, he has an incentive to recommend such securities above all others . . . In addition to the financial pressure on the salesman to prefer particular categories of securities, the practice in some firms of stepping up his rate of compensation for each transaction in a given month, if the dollar volume of all his commission business during that month exceeds a fixed level, provides an inducement to exert extra effort to generate enough business in the month to qualify for the higher rate.

Special Study Part I at 260–1. See also M. Meyer, *Conflicts of Interest: Broker-Dealer Firms; Report to the Twentieth Century Fund Steering Committee on Conflicts of Interest in the Securities Markets* 18 (1975).

[170] Specifically, Rule 10b–10(a)(7)(iii) requires the broker-dealer to disclose "the source and amount of any other remuneration received or to be received by him in connection with the transaction; *Provided, however,* That if in the case of a purchase, the broker was not participating in a distribution, or in the case of a sale, was not participating in a tender offer, the written notification may state whether any other remuneration has been or will be received and that the source and amount of such other remuneration will be furnished upon written request of such customer." Compliance with Rule 10b–10 does not necessarily shield a broker-dealer from antifraud liability for undisclosed compensation. *Ettinger* v. *Merrill Lynch, Pierce, Fenner & Smith,* 835 F.2d 1031 (3d Cir. 1987). See also Rule 206(3)–2(a)(2) under the Investment Advisers Act of 1940 (the "Advisers Act") (17 CFR 275.206(3)–2(a)(2)), requiring similar confirmation disclosure in connection with agency cross transactions for advisory clients.

[171] 17 CFR 240.15c1–6.

[172] See also NASD Rules of Fair Practice, Art. III, sec. 14, NASD Manual (CCH) ¶2164, which contains a corollary provision. Rule 206(4)–3 of the Advisers Act (17 CFR 275.206(4)–3) requires written disclosure by investment advisers to their clients in certain situations involving the payment of fees to persons performing solicitation activities for the adviser.

[173] In 1978, the Commission considered requiring confirmation disclosure of remuneration to associated persons of a broker-dealer, in connection with transactions in certain recommended securities, where such remuneration exceeded the "normal or customary" remuneration that would otherwise have been paid to the associated persons. At the same time, the Commission stated its belief that "a failure to disclose special payments intended to induce dealers to effect transactions with customers would violate the antifraud provisions of the [Exchange] Act." Securities Exchange Act Release No. 15219 (October 6, 1978), 43 FR 47495.

[174] The NASAA Report stated, "Spreads [in the penny stockmarket] often are extremely wide and appear to have little relation to rational factors, such as supply and demand, cost, and level of risk * * * For penny stockbrokers, the spread is often the real attraction of the job, since the differential often is split down the middle between the brokerage firm and the salesperson. It is through this lucrative arrangement that many penny stockbrokers are able to pile up monthly earnings of $20,000, $50,000, or more." 1989 Hearings at 193.

[175] Former Commission Chairman David S. Ruder has given the following illustration: For example, a broker-dealer firm may buy 20,000 shares at the bid price of 10 cents per share ($2,000) from one customer, and sell to another customer at the ask price of 20 cents per share ($4,000). The firm often gives 50 percent of the spread ($1,000) to its registered representative. A similar $4,000 trade at a typical wire house in a listed security would result in only a $42 gross agency commission with 30 percent or $12.60 to the registered representative.

See Ruder Remarks. See also 1989 Hearings, at 75–76 (statement of Frank Birgfeld, Director, District III, NASD).

[176] For example, the Commission and the courts have long recognized that the failure by broker-dealers to disclose excessive commissions is fraudulent. See *e.g., Duker & Duker,* 8 SEC 388, 388–

Continued

2. Description of the Proposed Rule

Section 15(g)(3)(A)(iii) of the Exchange Act requires the Commission to adopt rules to require both pre-transaction and confirmation disclosure by broker-dealers of compensation received or to be received by associated persons in connection with the transaction. Proposed Rule 15g–5 would require generally that any broker-dealer effecting a transaction in a penny stock must disclose to the customer (i) the amount of cash compensation received by certain associated persons of the broker-dealer in connection with the transaction and (ii) in certain cases, the amount of cash or other compensation received by such persons during the preceding year in connection with penny stock transactions generally.

The rule would apply to compensation received or to be received by an associated person [177] that is a natural person and has communicated with the customer in connection with the transaction. The rule is intended to reach those individuals who regularly solicit or recommend penny stock transactions, or otherwise communicate with customers in connection with those transactions and on whom customers are likely to rely in making investment decisions. Further, the rule includes a note emphasizing that payments under reciprocal arrangements in which sales agent commissions or other benefits paid in connection with a transaction were directed to associated persons other than the customer representatives in an attempt to avoid making the disclosures required by the rule would be considered to be sales agent compensation under the rule.

By operation of subparagraph (a)(2), described below, the rule could in some cases require disclosure with regard to persons who "communicate with the customer in connection with the transaction" but who will not receive any cash compensation in connection with that specific transaction. The Commission preliminarily believes that the rule requires this breadth in order to reach all associated persons who receive compensation in connection with penny stock transactions and who affect investment decisions by customers. However, the Commission requests comment on whether the application of the rule would be more appropriately limited to persons who receive compensation in connection with the particular transaction.

Subparagraph (a)(1) would require disclosure of either the aggregate or per share amount of cash compensation that the associated person has received or will receive in connection with the transaction, where such compensation is determined on a transactional or per share basis. Accordingly, the compensation could be expressed in either form, provided that per share compensation is unambiguously described as such. In addition, the compensation required to be disclosed would include that paid by any source other than the broker-dealer. For example, the Commission understands that in some cases, penny stock salespersons may receive direct compensation from issuers. The Commission believes that any such payments bear on the question of the salesperson's judgment and objectivity and should be included within the scope of the rule. The Commission requests comment on whether the required disclosure should segregate compensation received from persons other than the broker-dealer.

Subparagraph (a)(2) would require, in certain cases, disclosure with respect to associated persons covered by the rule of the aggregate amount of cash and other compensation received by the associated persons from any source during the preceding calendar year in connection with penny stock transactions generally. This provision would apply only if, during that period, the total amount of compensation received by an associated person in connection with penny stock transactions exceeded 25% of the total compensation received by such person in connection with all securities transactions.

Associated persons may sometimes be compensated for their sales activities through the payment of non-cash benefits. Where a salesperson receives a substantial portion of his or her compensation from transactions in penny stocks, the Commission believes that the disclosure of compensation should appropriately reflect the value of these benefits, both in order to fully inform customers and to prevent evasion of the rule's requirements. The value of non-cash benefits generally would be determined on the basis of fair market value. Where benefits are provided that have no reasonably ascertainable fair market value, the value determination would be made on the basis of the cost to the broker-dealer or other party providing the benefit.

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89 (1936), *Associated Securities Association*, 40 SEC 10, 14 (1960); *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (1943), *cert. denied*, 321 U.S. 786 (1944). In addition, the failure by a broker-dealer to disclose certain other information, such as the cost and best price obtainable for securities purchased through the exercise of investment discretion, or its status as a market maker or the capacity in which it acts with respect to securities in which it effects customer transactions, may also violate the antifraud provisions of the federal securities laws. *Arleen Hughes v. SEC*, 174 F.2d 969 (D.C. Cir. 1949); *Chasins v. Smith, Barney & Co., Inc.*, 438 F.2d 1167 (2d Cir. 1970); *Norris & Hirshberg v. SEC*, 177 F.2d 228 (D.C. Cir. 1949); *Sutton v. Shearson Hayden Stone, Inc.*, 490 F. Supp. 98 (SDNY 1980) (nondisclosure of complaints concerning salesperson by other customers); *Naftalin & Co., Inc.*, Securities Exchange Act Release No. 7220 (January 10, 1964) (firm failed to disclose arrangement whereby it sold shares to its customers acting as agent for both a salesman and the customers); *Brennan v. Midwestern United Life Insurance Co.*, 266 F. Supp. 702 (N.D. Ind. 1968) (firm failed to disclose it had engaged in transactions while insolvent and had built up a large short position in a security it recommended and sold to customers), *affirmed on other grounds*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989; *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). This principle applies also to adverse interests or potential adverse interests of individual salespersons. See, *e.g., Barthe v. Rizzo*, 384 F. Supp. 1063 (SDNY 1974) (failure to disclose financial interest of salesman in venture capital fund that he recommended to the customer). In particular, at least two court decisions have found that in some circumstances information concerning the remuneration paid to salespersons in connection with particular transactions or types of transactions is material. *Shivangi v. Dean Witter Reynolds, Inc.*, 637 F. Supp. 1001, 1005 (S.D. Miss. 1986), *aff'd*, 825 F.2d. 885 (5th Cir. 1987) (affirming dismissal on the grounds that the defendant lacked scienter without reaching the question of materiality); *Platsis v. E.F. Hutton & Co.*, No. G–86–1030, 1990 U.S. Dist. LEXIS 4828 (W.D. Mich. April 24, 1990) (failure to disclose existence and amount of production credits received by sales agent recommending purchase of utility bonds held in inventory, as well as the existence and amount of the mark-up charged). See *generally*, R. Greene, "Differential Commissions as a Material Fact," 34 Emory L. J. 509, 542 (1985), suggesting that disclosure of the fact that a sales agent stands to gain a disproportionately high commission for the sale of a particular security may often be more important to the investor than the amount of the mark-up or the fact that the firm serves as a market maker. The Commission and courts have indicated that broker-dealers engaged in high pressure sales tactics may be held to especially high standards in their dealings with customers. See Jacobs, *The Impact of Securities Exchange Act Rule 10b–5 on Broker-Dealers*, 57 Cornell L. Rev. 869, 927 (1972), citing *Berko v. SEC*, 316 F.2d 137, 142 (2d Cir. 1963), *Hanly v. SEC*, 415 F.2d 589, 597 n. 14 (2d Cir. 1969), and *Harold Grill*, 41 SEC 321, 324–25 (1983); and *SEC v. Great Lakes Equities Co.*, (current) Fed. Sec. L. Rep. (CCH) ¶95,685, at 98,206–7 (E.D. Mich. September 4, 1990).

[177] Under section 3(a)(18) of the Exchange Act (15 U.S.C.) 78c(a)(18)), the term "associated person of a broker or dealer" includes "any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of this title (other than paragraph (6) thereof)." The Penny Stock Act expanded the Commission's authority to impose a range of sanctions on persons associated or seeking to become associated with broker-dealers, as well as certain other persons participating in an offering of penny stocks. See the discussion herein at section III.A.

In addition, salespersons also are frequently provided compensation on other than a transactional or per share basis. For example, bonus payments may be dependent on reaching a minimum share volume in particular securities for which the broker-dealer acts as a market maker. Subparagraph (a)(2) is designed to permit a workable annual calculation of payments that are either in a non-cash form or are not readily allocable to specific transactions. The Commission requests comment on whether an annual period is an appropriate period in which to measure such payments, or whether it would be more useful to measure such payments on an alternative, such as a quarterly or monthly, basis.

3. Request for Comment

In addition to items as to which the Commission specifically solicits comment elsewhere, the Commission requests comment generally on the value to investors of the information that the proposed rule would require to be disclosed and the additional costs that would be imposed on broker-dealers and their associated persons.

H. Disclosure Procedures for Rules 15g–3, 15g–4, and 15g–5

Pursuant to the Penny Stock Act, proposed Rules 15g–3, 15g–4, and 15g–5 require a broker-dealer effecting penny stock transactions that are not exempted under proposed Rule 15g–1 to disclose to its customers certain information with respect to quotations, broker-dealer compensation, and associated person compensation at two different points in time.[178] The initial disclosure must be given to the customer by the broker-dealer orally or in writing, prior to effecting any transaction in a penny stock. The broker-dealer also is required to provide disclosure at the time of confirming the transaction.

The Commission expects that broker-dealers normally would satisfy the pre-trade disclosure requirement by providing the information to the customer orally during the conversation in which the customer agrees to the transaction. As a practical matter, however, the Commission recognizes that in some circumstances it may be difficult for the broker-dealer to obtain from its trading department the information necessary to comply with Rules 15g–3, 15g–4, and 15g–5 before effecting a transaction. Therefore, pursuant to the exemptive authority granted to it under section 505 of the Penny Stock Act,[179] the Commission proposes to exempt broker-dealers from the pre-trade disclosure requirement of the Penny Stock Act, provided that the broker-dealer satisfies certain conditions set forth in the exemptive provision of the proposed rules. Under the exemption, the broker-dealer is required to provide the required disclosure promptly after effecting the securities transaction, and at the time the broker-dealer provides this information, it must inform the customer that the customer has the unconditional right to cancel the transaction until the end of the following business day.[180] The customer or its authorized agent must actually receive this information and be informed of its right of cancellation before the one-day cancellation period begins. The broker-dealer may not attach any fees or penalty to the customer's exercise of the right of cancellation, or otherwise discourage the customer from exercising this right.[181]

In addition, the proposed rules require broker-dealers seeking to use the exemption to inform the customer in the written disclosure at the time of the confirmation that the customer has the right to cancel the transaction, that the broker-dealer has previously informed the customer of this right orally or in writing, as the case may be, and that the customer has not exercised this right.

The second point at which disclosure must be made is on the customer confirmation. Proposed Rules 15g–3, 15g–4, and 15g–5 require broker-dealers to provide written disclosure of the information required thereunder prior to or at the time of providing customers the confirmation disclosure required under Rule 10b–10 of the Exchange Act.[182] The inclusion of the information required under proposed Rules 15g–3, 15g–4, and 15g–5 on the Rule 10b–10 confirmation, or together with such confirmation, would comply with this requirement.

The Commission requests comment whether allowing broker-dealers to provide the required information orally will provide adequate protection to customers, or whether the information required to be disclosed to the customer prior to effecting a transaction in a penny stock should be in writing. The Commission also requests comment on whether the proposed exemption from disclosure of the required information prior to the trade through a post-trade right of cancellation offers equivalent protection to customers, and whether it would be of use to broker-dealers in satisfying their requirements under the rules.

I. Rule 15g–6: Monthly Account Statements

1. General Description of Proposed Rule

Proposed Rule 15g–6 would require broker-dealers that sell penny stocks to their customers to provide the customers with monthly account statements containing market value information pertaining to these securities. In general, the account statement would describe all such securities held in a customer's account as of the statement date, including the purchase price paid by the customer. Also, the account statement would contain price information for the security based on recent transactions in, or independent bids for, the security, where such information is available, or where such information is not available, a statement to that effect.

The Commission is proposing the rule pursuant to section 15(g)(3)(B), which provides that the Commission by rule

> * * * shall require brokers and dealers to provide, to each customer whose account with the broker or dealer contains penny stocks, a monthly statement indicating the market value of the penny stocks in that account or indicating that the market value of such stock cannot be determined because of the unavailability of firm quotes.

In its report, the Committee stated that it "views these mandatory monthly statements as crucial for providing investors more accurate, up-to-date information regarding all of their holdings of penny stocks." [183]

Paragraph (a) of Rule 15g–6 would provide that it shall be unlawful for a broker or dealer that has effected the

[178] See paragraph (b) in proposed Rules 15g–3, 15g–4, and 15g–5. The Penny Stock Act reads, in relevant part: "The Commission * * * by rule or regulation * * * shall require brokers and dealers to disclose to each customer, prior to effecting any transaction in, and at the time of confirming any transaction with respect to any penny stock [the information required under the Commission's rules] " 15 U.S.C. 78*o*(g)(3)(A).

[179] 15 U.S.C. 78*o*(g)(4).

[180] The Commission believes that, in accordance with industry practices with respect to agency transactions, the broker-dealer would be responsible for completion of the trade with respect to the counterparty even if its customer exercises its right of cancellation under the proposed rules.

[181] It should be emphasized that broker-dealers are required without exception to disclose their market maker status under proposed Rule 15g–7 prior to effecting the transaction in a penny stock, and are referred to section III.J of this release for a discussion of the requirements of that rule.

[182] 17 CFR 240.10b–10. The confirmation must be provided "at or before completion" of the transaction. See 17 CFR 240.10b–10(a).

[183] House Report 30.

sale of a penny stock to a customer [184] to fail to give or send to the customer a monthly account statement setting forth certain specified information concerning the security. Where the broker-dealer has sold more than one penny stock to the same customer, the required information concerning each security would be contained on one account statement.

Rule 15g–6 would apply to broker-dealers that deal directly with customers in selling penny stocks. Broker-dealers that do no more than provide carrying or clearing services in connection with sales of penny stocks would not thereby become subject to the account statement requirement. In this regard, it is important to note that the rule is not designed to preclude common clearing arrangements pursuant to which clearing firms provide various reporting services, including the preparation and sending of confirmations and account statements, to customers of introducing broker-dealers. An introducing broker-dealer that effects the sale of a penny stock to a customer would be permitted to delegate to another entity its obligation to provide account statements, although it would remain responsible for the fulfillment of the obligation.

Because Rule 15g–6 would apply to penny stocks sold by a broker-dealer in transactions with or for a customer, it would apply to penny stocks acquired by a customer in recommended transactions through a broker-dealer acting in either an agency or a principal capacity. Account statements also would be required to be provided by any legal successor to a broker-dealer that is required to provide account statements under the rule.

The rule would require account statements to be given or sent within ten days following the end of each period in which account statement securities are held in the customer's account. The Commission understands that, in general, firms that currently provide periodic account statements to their customers send the statements within one week after the end of each period, and the Commission preliminarily believes that firms should be able to provide the information within ten days. However, the Commission requests comment on the feasibility of this ten-day requirement, or whether a longer period would prove more workable while preserving the usefulness of the information to customers.

Pursuant to the exemptive authority provided by section 15(g)(4), the rule would provide a conditional exemption from the monthly statement requirement for broker-dealers that effect penny stock transactions for a particular customer on a very isolated or infrequent basis. Specifically, if a broker-dealer has not effected a transaction in any penny stock, whether a purchase or sale, for or with its customer for a period of six consecutive calendar months, the broker-dealer thereafter would be permitted to provide account statements on a quarterly basis, so long as no further penny stock transactions are effected in the account. Quarterly statements would then be required to be provided within ten days following the end of each such quarterly period.

The alternative of quarterly statements would not become available until after the expiration of six full calendar months. Further, once a broker-dealer has become entitled to send quarterly statements to a particular customer, if the broker-dealer effects a penny stock transaction for or with the customer's account, the broker-dealer will again become required to provide statements on a monthly basis, beginning with respect to the month in which the transaction occurs.

For example, if the broker-dealer sells a penny stock to a customer on March 15 and becomes subject to Rule 15g–6 by virtue of that transaction, the broker-dealer will be required to send monthly account statements to the customer by April 10. If the broker-dealer does not effect any further penny stock transactions for or with the customer during the period from March 15 to December 31 of the same year, the broker-dealer may provide to the customer a quarterly statement covering the period from October through December.

Where a broker-dealer effects penny stock transactions on an isolated basis, the Commission preliminarily believes that it may be appropriate to permit the broker-dealer to avoid the expense of monthly statements in favor of a quarterly procedure. The customer's need for account information on a monthly basis may be diminished where there is no account activity involving penny stocks over an extended period of time. The Commission requests comment as to whether such a proviso is appropriate, or whether some other time period, such as one year, without account activity involving penny stocks would be preferable.

The rule would apply to penny stocks, as defined in section 3(a)(51) and proposed Rule 3a51–1, held in the customer's account as of the end of the statement period. Accordingly, if a security that was within the penny stock definition at the time it was sold to a customer subsequently ceased to meet that definition, the account statement requirement would be suspended, but only for so long as the security was not a penny stock. Specifically, if a security did not meet the definition of penny stock in section 3(a)(51) and Rule 3a51–1 adopted thereunder as of the end of a statement period, the broker-dealer would not be required to provide an account statement with respect to that particular security for that particular period.

Further, subparagraph (a)(1) of the rule expressly would not apply with respect to any period for which an account statement for a particular penny stock would otherwise be required if, at the end of the period, transactions in the security would be exempted from the rule by operation of Rule 15g–1(a)(2). That provision provides an exemption for transactions in securities of an issuer that meets certain requirements relating to net tangible assets, based on recent information that is reviewed by the broker-dealer. Accordingly, broker-dealers would not be required to furnish information relating to a particular penny stock for any monthly or quarterly period, as the case may be, in which the issuer of the securities would qualify for the net tangible assets exemption. This determination would be made at the end of the period, based on financial statements dated less than fifteen months prior to such date that the broker-dealer has reviewed and has a reasonable basis for believing are accurate as of such date. [185] This provision would apply only to the broker-dealer's obligation to furnish information relating to the exempted security. The broker-dealer would remain obligated to furnish information concerning any other penny stocks that are held for the customer's account and are not exempted from the rule.

2. Objectives of the Proposed Rule

Many firms currently provide monthly or quarterly account statements, including market value information, to their customers, although there presently is no general requirement that broker-dealers furnish account statements. [186]

[184] Pursuant to subparagraph (e)(1) of the proposed rule, the term "customer" would not include a broker or dealer. Accordingly, transactions among broker-dealers would not trigger the application of Rule 15g–6.

[185] See the discussion of proposed Rule 15g–1 at Section III.C. herein.

[186] Broker-dealers that already furnish monthly account statements would not need to furnish a

Continued

Where there has been a substantial decline in the value of the securities, the broker-dealer may have an incentive to withhold this information. In the absence of any specific requirement that broker-dealers furnish to customers market information on their holdings, customers often are unaware that the value of their investments has decreased.

In the past, unscrupulous broker-dealers have seized upon the lack of market information available to investors to encourage further investment, or to dissuade investors from selling securities previously purchased, based upon exaggerated claims of stock performance. In the Commission's experience, the extremely limited access by investors to information concerning the current market value of their securities, to the extent that such market value can be determined, has been a key element in the success of many fraudulent penny stock schemes. In the Commission's view, the additional secondary market information that would be required by Rule 15g–6 would provide investors with information necessary to evaluate broker-dealers' investment recommendations and should serve as an important means of preventing fraud.

The Commission recognizes that, in some cases, the broker-dealer may not be able to obtain the information because of a lack of market interest in the security. In these cases, the Commission believes that the fact that there is a lack of reliable market information concerning the security is itself an important piece of information needed by the investor in order to evaluate the extent of his or her risk exposure and whether to buy similar securities from the broker-dealer.

3. Information to be Contained in Account Statements

Rule 15g–6 would require that each account statement provide the specified information as of the last trading day of the period to which the statement relates. The rule would require the disclosure of two general categories of information, each of which is more fully described below:

(i) general identifying and historical information; and

(ii) where available, certain price and bid information related to recent sales of or bids for the security.

i. Identifying Information. For each penny stock held in the customer's account, subparagraph (b)(1) of the rule would require the statement to provide the identity and number of shares or units of the security held in the account, as well as the date or dates of purchase.[187] In addition, the statement would reflect the purchase price paid by the customer, including any mark-up, commission, or similar form of broker-dealer remuneration. The Commission preliminarily believes that, for most investors, purchase price information will be most meaningful if it reflects the aggregate amount paid by the customer to the broker or dealer to acquire the security. This is particularly true in the context of the penny stock market, where mark-ups, spreads, and commissions often are disproportionately large in relation to market value. The Commission requests comment, however, as to whether purchase price information would be more meaningful if it included the amount paid, exclusive of mark-ups and commissions, as well as separate disclosure of such payments.

ii. Market Value. Subparagraph (b)(2) of the rule would require the broker-dealer to provide information relating to the estimated market value of each penny stock held in the account. For purposes of this provision, the "estimated market value" of each penny stock would be based on recent purchases of the security by the broker-dealer furnishing the statement, or on bid prices for the security by other broker-dealers, where such information is available. Under subparagraph (b)(2)(i), if the broker-dealer has effected at least ten Qualifying Purchases in the security during the last five trading days to which the statement relates, the statement would be required to disclose the value of the shares held for the customer's account, based on the weighted average price per share paid by the broker-dealer in all Qualifying Purchases in the security during that period. Subparagraph (e)(1) of the proposed rule defines "Qualifying Purchases" as *bona fide* purchases by the broker-dealer for its own account, each involving at least 100 shares, but excluding block purchases involving more than five percent of the outstanding shares or units of the security. This provision of the proposed rule recognizes that the broker-dealer that has sold a penny stock to its customer is often the most likely potential purchaser of the security. Lacking other reliable quotation or transaction information, the price at which the broker-dealer furnishing the statement has recently purchased the security may provide the best general indication of the price at which the customer could realistically dispose of the same security.[188] Moreover, this information is known by the broker-dealer and can be derived from information retained in its records. Block purchases of more than five percent have been excluded because of the distorting effect that transactions of this size are likely to have on the per share transaction price.

If there are an insufficient number of Qualifying Purchases in the security during the period, subparagraph (b)(2)(ii) would apply. That provision states that, where there are at least three Qualifying Bids for the security made during the last five trading days of the period to which the statement relates, the statement must disclose the value of the shares held for the customer's account, based on the average of all Qualifying Bids as of the end of each day of the five-day period on which any Qualifying Bids were made. Subparagraph (e)(2) defines "Qualifying Bids" as bona fide, priced interdealer bid quotations entered into any interdealer quotation system, and which are made by independent market makers in the security. "Interdealer quotation system" is defined by reference to the definition contained in Rule 15c2–7(c),[189] i.e., "any system of general circulation to brokers or dealers which regularly disseminates quotations of identified brokers or dealers but shall not include a quotation sheet prepared and distributed by a broker or dealer in the regular course of his business and containing only quotations of such broker or dealer."[190]

separate document, provided that the statement contains all the information and is sent within the time period required by the proposed rule. Certain rules of the Commission or self-regulatory organizations may require that account statements be provided by certain broker-dealers or with respect to certain accounts. See Rule 15c3–3 (17 CFR 240.15c3–3) (requiring statements in connection with the use of customer free-credit balances by the broker-dealer in its operations); Rule 10b–16(a)(2) (17 CFR 240.10b–16(a)(2)) (requiring statements containing information with respect to credit extended by the broker-dealer); New York Stock Exchange Rule 409, 2 New York Stock Exchange Guide (CCH) ¶ 2409.

[187] This information presently is required to be included on trade confirmations pursuant to Rule 10b–10.

[188] By requiring the disclosure of historical or average price information concerning a security, the Commission is not suggesting that broker-dealers would have a duty to effect future transactions at the prices reflected on the account statement, although they would of course remain obligated to obtain the best available execution for their customers.

[189] 17 CFR 240.15c2–7(c).

[190] The definition would include systems and publications such as the pink sheets and the NASD's OTC Bulletin Board but would not include proprietary trading systems that provide quotations only to a limited number of subscribing broker-dealers.

Accordingly, where there are insufficient Qualifying Purchases by a broker-dealer furnishing the statement, subparagraph (b)(2)(ii) would provide an indication of the "inside" price that third party market makers [191] have indicated their willingness to pay, within a reasonable time proximity to the date of the account statement. Under this provision, where the security is quoted on the OTC Bulletin Board or other automated quotation system, the estimated market value would be based on the last Qualifying Bid entered in the system by each market maker on each day in the five-day period on which any Qualifying Bids were entered in the system. If the security is quoted in another type of interdealer quotation system, such as the pink sheets, the estimated value would be based on the average of all Qualifying Bids for the security shown in the system during the same five-day period.

The Commission is aware that bid quotations for penny stocks often are not binding or firm for any number of shares and do not necessarily reflect a reliable price at which an investor would be able to resell the securities. The Commission preliminarily believes, however, that where three or more independent market makers for a security exist, and where those dealers have provided recent prices indicating their interest in purchasing the security, these quotations have sufficient potential value to investors to justify mandating their communication to investors in the account statement.[192]

The proposed rule provides that market value information must be based on *bona fide* transactions or bids. If the broker-dealer knows or reasonably should know that certain price or bid information is not derived from legitimate business activity, but instead is generated for the purpose of creating apparent market activity, this information would not satisfy the requirements of the rule.[193] In this connection, the definition of "Qualifying Bids" specifically refers to quotations entered by market makers that are independent of each other and the broker-dealer furnishing the account statement. Thus, where the broker-dealer knows or reasonably should know that a market maker providing a bid for a security is acting in concert with or controls or is controlled by the broker-dealer or other market makers for that security, the bid would not be a "Qualifying Bid."

Under subparagraph (b)(2)(iii) of the proposed rule, in the absence of both Qualifying Purchases and Qualifying Bids that satisfy the requirements of subparagraphs (b)(2)(i) and (b)(2)(ii), the account statement must specifically indicate that there is "no estimated market value" for the security. In addition, the legend that must be contained in each account statement under paragraph (c), described further below, would indicate that there is a lack of available information concerning recent purchases or bids for the security.

The requirement of subparagraph (b)(2) that estimated market values be provided in the account statement is based on an assumption that such information, where it is available and easily accessible, should be made available to customers who have little or no access to information that reflects on the value of their securities holdings. The Commission believes that the danger that customers provided with this information may misinterpret or give undue weight to it can be ameliorated by additional disclosure, described below. The Commission requests comment on the extent to which broker-dealers selling penny stocks currently provide account statements to their customers, the costs entailed in providing the required disclosures, and whether other methods or measures of price or quotation information would provide more useful or reliable information to customers.

4. Prescribed Legend

Paragraph (c) of the proposed rule specifies certain standard information, in the form of a prescribed legend to be contained in all account statements provided under paragraph (a). The legend is required to be "conspicuously displayed." In order to be conspicuous, large or otherwise distinguishable type should be used to set apart the legend from the other information contained in the statement.[194]

The legend states that the market for the securities may be limited. In addition, the legend indicates that (i) with respect to securities for which estimated market values have been furnished, such information is based on recent purchases by the broker-dealer furnishing the statement or on bid prices by other broker-dealers, and this information may not serve as a reliable indicator of the price that the customer could obtain in selling the securities, (ii) with respect to securities listed in the account statement for which estimated market values have not been provided, such values cannot be determined because sufficient purchase or bid information is not available, and (iii) the securities are subject to the payment of commissions or mark-downs on resale. The legend also states that the broker-dealer furnishing the statement may not refuse to accept the customer's order to sell the securities. This language has been included in response to the Commission's understanding that fraudulent penny stock schemes sometimes include the firm's refusal to accept sell orders.

The Commission requests comment on whether the language prescribed by paragraph (c) of the rule would serve both to provide useful information and to allow investors to view the information provided by the account statements in the appropriate context.

5. Recordkeeping

Paragraph (d) of the rule would require broker-dealers furnishing account statements to maintain written records of the information described in paragraph (b) and to preserve those records for the periods specified in Rule 17a–4 of the Exchange Act.[195] This

[191] The term "market maker" is defined by section 3(a)(38) of the Exchange Act [15 U.S.C. 78c(a)(38)] to include "any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an interdealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis."

[192] It is contemplated that, until a quotation system for penny stocks complying with the requirements of Section 17B of the Exchange Act is operational, Qualified Bids, if they exist with respect to a particular security, will be found in the NASD's OTC Bulletin Board, the pink sheets, or other similar printed or electronic systems of general circulation among brokers and dealers. The proposed rule does not contemplate that broker-dealers furnishing account statements must make any independent, direct inquiry of dealers in order to derive unpublished indications of interest.

[193] Moreover, the participation by a broker-dealer in generating such artificial information generally would violate the antifraud provisions of the federal securities laws. The Commission has found that broker-dealers engaged in unlawful manipulation by arranging with other broker-dealers to appear in the pink sheets and to guarantee a purchase of shares against loss, or by compensating another broker-dealer for maintaining quotations in its own name. *Masland, Fernon & Anderson*, 9 S.E.C. 338, (1941); *SEC* v. *Scott Taylor & Co.*, 183 F. Supp. 904 (SDNY 1959); *M.S. Wien & Co.*, 23 S.E.C. 735, 739–745 (1946); *Adams & Co.*, 33 S.E.C. 444, 449 (1952); *Junius A. Richards*, 4 S.E.C. 742 (1939).

[194] See Securities Exchange Act Release No. 26805 (May 10, 1989), 54 FR 21144, 21153 (approving rule changes by certain self-regulatory organizations to require, among other things, certain prominent disclosures relating to pre-dispute arbitration provisions contained in broker-dealer account agreements).

[195] 17 CFR 240.17a–4. Under subparagraph (b)(4) of that rule, a broker-dealer is required to keep for three years, the first two years in an accessible place, "originals of all communications received and copies of all communications sent by such [broker-dealer] (including inter-office memoranda and communications) relating to his business as such.' Much of the information contained in account

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recordkeeping requirement is intended to assure that broker-dealers will be able easily to demonstrate compliance with the rule and to respond to questions from customers concerning the specific bases for the information that is contained in the account statements.

6. Request for Comment

The rule is designed to provide information concerning the market for penny stocks to investors in these securities, without imposing an undue burden on brokers and dealers that sell the securities. The Commission preliminarily believes that information that reflects upon the value of account statement securities should be provided where it is sufficiently valid and reliable that the potential value of the information to investors outweighs the dangers that it will prove misleading or be used for fraudulent purposes.

In proposing the rule, the Commission has attempted to strike this balance, while at the same time cautioning customers that, in light of the limited market for the securities, they should not give undue weight to price or bid information that is furnished. Although, as noted above, there currently is no general requirement that broker-dealers provide periodic account statements to customers, many broker-dealers routinely provide such statements for business reasons. These account statements frequently contain information concerning customer positions and the current market values of securities held in a customer's account. While proposed Rule 15g–6 may require disclosure of some information not currently contained in customer account statements, the Commission anticipates that in many cases broker-dealers will be able to comply with the rule by supplementing the statements they now provide. The Commission specifically requests comment on the extent to which the rule would require broker-dealers to depart from their current practice.

In addition, the Commission solicits comment generally on the value to investors of the information prescribed by the proposed rule and the costs to broker-dealers that would be entailed. The Commission is interested particularly in quantitative estimates of the incremental expense involved in preparing account statements, whether the required information could be generated through automated means, and the ease with which such information could be integrated into existing account statements.

J. Rule 15g–7: Penny Stock Market Makers

1. Description of the Proposed Rule

Proposed Rule 15g–7 would require that where a broker-dealer, or an affiliate of a broker-dealer, is a sole market maker with respect to a penny stock, the broker-dealer must disclose this fact to its customer and its or its affiliate's influence over the market for the security, prior to effecting any transaction in the security for the customer's account and in writing at or prior to the sending of the trade confirmation. Rule 15g–7 also would prohibit certain representations by a market maker of a penny stock or an affiliate that effects a transaction in the security with a customer that the transaction is being effected "at the market" or at a price related to the market price.

As indicated, the rule would apply both to penny stock market makers and to broker-dealers that control, are controlled by, or are under common control with, such firms ("affiliates"). The Commission preliminarily believes that investors' need for information concerning market control by an executing broker-dealer or its affiliate and for protection from misrepresentations concerning price exists also where control is exerted by a related entity. In addition, the Commission is concerned that penny stock market makers may otherwise attempt to evade the rule's requirements by using an affiliate to effect customer transactions on an agency basis.

The rule expressly would not apply to transactions by broker-dealers with other broker-dealers, or to market making activities conducted by specialists on a national securities exchange. The Commission believes that this disclosure would not be necessary in these limited circumstances, given the market position of broker-dealers and the existence of exchange rules governing the conduct of specialists.

The rule also would not apply if the broker-dealer, at the time of the transaction, had reasonable grounds to believe that there was an independent market for the security. Accordingly, if a market maker in a penny stock or its affiliate effects a transaction in the security for the account of its customer and fails to comply with the requirements of the rule, it must be able to demonstrate a good faith and reasonable belief that an independent market for the security existed at the time of the transaction. Because of the near-monopoly on information concerning penny stocks held by market makers in those securities, the Commission believes that the circumstances that could give rise to such a reasonable belief would be extremely limited.[196] The Commission requests comment, however, on the extent to which market makers may be uncertain as to the presence of an independent market and as to the appropriateness and usefulness generally of this reasonable belief standard.[197]

The Commission is proposing to adopt Rule 15g–7 under the general rulemaking authority granted by section 15(g)(5)[198] of the Exchange Act, which provides that

> [i]t shall be unlawful for any person to violate such rules and regulations as the Commission shall prescribe in the public interest or for the protection of investors or to maintain fair and orderly markets (A) as necessary or appropriate to carry out this subsection; or (B) as reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices with respect to penny stocks.

The House Report noted the substantial effect that control of the market for a security by one or a few firms, which are often affiliated, may have in furthering penny stock fraud.[199] Because the control of the market for individual penny stocks by individual broker-dealers exacerbates and is intertwined with the absence of information for investors and their exposure to fraud and manipulation, the Commission preliminarily believes that Rule 15g–7 is an appropriate means of carrying out the purposes of section 15(g) and is reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices with respect to penny stocks.

2. Disclosure of Sole Market Maker Status

Where only one dealer acts as a market maker in a security, by holding itself out as being willing to buy and sell the security for its own account on a regular or continuous basis, the market for the security is necessarily a non-

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statements under the proposed rule undoubtedly would be independently documented by other records required to be maintained under Rule 17a–4.

[196] For example, a penny stock market maker could be excused from disclosing that it was the sole market maker with respect to a security if, at the time of the transaction, an independent dealer held itself out as a market maker and provided quotations for the security on an interdealer quotation system but in fact was not then willing to effect transactions in the security, and the penny stock market maker relied in good faith on the information that was available to it.

[197] See discussion below concerning Rule 15c1–8, which contains a similar standard.

[198] 15 U.S.C. 78o(g)(5).

[199] House Report, at 11, 20.

competitive one, and the dealer can be said to exercise substantial influence over that market. A market that is influenced in this way is particularly susceptible to fraud and manipulation,[200] and many instances of abuse in the penny stock market have involved transactions in a stock by controlling broker-dealers. This concern was identified in 1963 by the Special Study, which recommended that dealers in the OTC market be required to make pre-transaction disclosure of the absence of an independent market.[201]

The influence by a sole market maker over market price is most readily apparent where the market maker is acting or has acted as an underwriter for the issuer's securities, or where there has been some other direct relationship between the issuer and the market maker. The Commission requests comment on whether the application of paragraph (a) should be limited to these situations, and on the extent to which any sole market maker for a penny stock exerts influence over the market for the security.

In some cases, a broker-dealer that is not the only market maker for a penny stock may effectively control or dominate the market for the security and as a result may arbitrarily establish transaction prices in the security. The proposed rule, however, does not specify the disclosure required in these situations because the Commission preliminarily believes that the question of market control in such cases presents problems of definition and often may require a subjective assessment by the broker-dealer. The Commission requests comment on whether the scope of the rule should be expanded in this regard.

By proposing Rule 15g–7, the Commission does not mean to suggest that disclosure of influence over the market and similar important information by a broker-dealer would not otherwise be required by the general antifraud provisions, with respect both to penny stocks and other securities. For example, it is well established that the antifraud provisions of the Exchange Act apply to the failure of a broker-dealer that effects transactions in a security for or with its customers to disclose that it is a market maker in the security.[202] Paragraph (a) of the proposed rule is designed expressly to require disclosure of certain information that, based on experience, poses a risk of broker-dealer fraud.[203]

Further, irrespective of the potential for fraud, the status of a dealer or its affiliate as the sole market maker for a security implies that it may be difficult for an investor to resell the security to or through any other party. The Commission preliminarily believes that penny stock customers should be aware of the influence exercised by the dealer from or through which they execute transactions. This knowledge will allow investors to more carefully scrutinize the conduct of broker-dealers and make more informed investment decisions concerning those securities or other securities recommended by securities salespersons.

The term "market maker" is defined by section 3(a)(38) of the Exchange Act [204] as "any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an interdealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis." Accordingly, a dealer that provides quotations for a penny stock in the OTC Bulletin Board, the pink sheets, or similar interdealer publications or systems presumptively would be considered as a market maker with respect to that security. In addition, a dealer that does not provide quotations in a recognized system but that nevertheless holds itself out to other broker-dealers or other customers on a regular or continuous basis, by any means of advertising or solicitation, as being willing to buy and sell a penny stock, will fall within this category.

The disclosure requirement of subparagraph (a) would apply only to broker-dealers that are the sole market makers in penny stocks and their affiliates. Thus, the disclosure would not be required of an OTC market maker where there exists another broker-dealer acting as an exchange specialist with respect to the security. Otherwise, the broker-dealer would be permitted to omit the disclosure required by subparagraph (a) only where it has reasonable grounds to believe that a market for the security exists other than that made, created, or controlled by the dealer or its affiliate.

Under paragraph (b), the disclosure must be provided both orally or in writing, prior to the transaction, and in writing, at or prior to the sending of the trade confirmation. Unlike the corresponding paragraphs of Rules 15g–3, 15g–4, and 15g–5, this provision would not permit the broker-dealer to furnish the information after execution, conditioned on the customer's right to cancel the transaction. Because the broker-dealer's status as a sole market maker will be based on facts in existence and known by the broker-dealer at the time of the transaction, the Commission believes that the information should in all cases be provided to the customer in advance of the transaction.

The Commission has not attempted to prescribe mandatory language to be used to satisfy the written disclosure requirement but would expect that the disclosure would clearly indicate that the broker-dealer exerts substantial influence over the market for the security. The Commission requests comment on whether mandated written language would more fully serve the purpose of the proposed rule.

3. Prohibited Representations

Paragraph (c) of the rule would provide that a market maker in a penny stock or an affiliate effecting a transaction in that security with a customer may not represent that the transaction is being effected "at the market" or at a price related thereto unless the broker-dealer has reasonable grounds to believe that a market for the security exists other than that made, created, or controlled by it or its affiliate. This language is similar to that of Rule 15c1–8 under the Exchange Act, which prohibits certain representations related to market price by broker-dealers that participate or have a financial interest in distributions of OTC securities. [205] Rule 15c1–8 has been an

[200] *See Alstead, Strangis & Dempsey, Inc.* 47 S.E.C. 1034 (1984) (charging of excessive mark-ups by controlling market maker); *Jack W. Pagel*, Securities Exchange Act Release No. 22280 (August 1, 1985), *aff'd, Pagel, Inc.* v. *SEC*, 803 F.2d 942 (8th Cir. 1986) (abuse of underwriter's position in precluding a competitive market from arising by controlling wholesale prices).

[201] *Special Study* Part 2, 677 (1963).

[202] *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128 (1972); *Chasins* v. *Smith Barney & Co., Inc.*, 438 F.2d 1167, 1172 (2d Cir. 1970); *Cant* v. *A.G. Becker & Co.*, Fed. Sec. L. Rep. (CCH) ¶ 93,347 (1971–1972 Transfer Binder) (N.D. Ill. 1971). Rule 10b–10 (17 CFR 240.10b–10) requires that broker-dealers that are market makers in an equity security, when acting as principal in effecting a transaction in the security with a customer, disclose this fact on the trade confirmation.

[203] See also Rule 15c1–5 (17 CFR 240.15c1–5) (requiring pre-transaction disclosure of a control relationship between a broker-dealer and the issuer of the security).

[204] 15 U.S.C. 78c(a)(38).

[205] 17 CFR 240.15c1–8. Rule 15c1–8 was adopted (as Rule MC8) in 1937 as one of a series of antifraud provisions aimed at broker-dealer practices. Securities Exchange Act Release No. 1330 (August 4, 1937). The text of Rule 15c1–8 is as follows: "The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in Section 15(c)(1) of

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important tool in the prosecution by the Commission of enforcement actions related to penny stock fraud. [206]

Paragraph (c) is designed to complement the affirmative disclosure obligations of paragraph (a) by prohibiting express or implied representations by penny stock market makers and their affiliates that cause customers to believe incorrectly that there is an independent market for the security. For instance, a representation by a broker-dealer to a customer that it is selling or buying a security at or below the market price necessarily implies the existence of an independent market. Where this is not the case, the Commission believes that such representations are *per se* misleading.

The prohibition would not be limited to an explicit representation that securities are being sold or purchased at or below the "market price." Any statements that necessarily imply this representation would also be prohibited. The Commission and the courts have long held that customer transactions by broker-dealers ordinarily carry an implied representation that the price to the customer is reasonably related to the prevailing market price. [207] In addition, the Commission has found that salespersons who solicited buy orders from their customers and "quoted the market to their customers in the ordinary manner" violated Rule 15c1–8 where no independent market existed. [208]

Paragraph (c) would apply to any market maker in a penny stock, whether or not it is the "sole" market maker. Because this provision is meant to prohibit misleading representations, rather than impose an affirmative disclosure obligation, the Commission preliminarily believes that it is appropriate to impose the requirement on all penny stock market makers, which are clearly in a position to determine whether they control the market for individual securities and should avoid representations that indicate otherwise.

4. Request for Comment

In addition to items as to which the Commission specifically solicits comment elsewhere, the Commission requests comment generally on the potential effectiveness of the proposed rule in preventing misrepresentations and providing useful information to investors in connection with penny stock transactions and the additional costs that would be imposed on broker-dealers thereby.

IV. Rule 15c2–6

As discussed above, Rule 15c2–6 also currently imposes obligations on broker-dealers with respect to low-priced securities that are traded in the non-NASDAQ OTC market. In general, Rule 15c2–6 prohibits a broker-dealer from selling to or effecting the purchase of a "designated security" for any person, unless the broker-dealer has approved the purchaser's account for transactions in designated securities and has received the purchaser's written agreement to the transaction, or unless the transaction specifically is exempt from the requirements of the rule. In order to simplify broker-dealer compliance with both Rule 15c2–6 and the disclosure rules under the Penny Stock Act, the Commission intends to amend Rule 15c2–6 at a later date to make the rule consistent, where appropriate, with the penny stock rules. The changes to Rule 15c2–6 would be primarily structural, and therefore would not significantly alter the scope of the rule.

Currently, the definitions and exemptions in proposed Rules 3a51–1 and 15g–1 differ from those in Rule 15c2–6 in a number of respects. [209] One example of a possible conforming amendment to Rule 15c2–6 would be to incorporate in Rule 15c2–6 proposed Rule 15g–1's narrower exemption for transactions in securities issued by an issuer in operation for less than three years, as well as the narrower exemption for transactions with accredited investors. Another example would be to incorporate in Rule 15c2–6 proposed Rule 15g–1's limited exemption for NASDAQ securities, so that only agency cross transactions and transactions involving a NASDAQ market maker or an underwriter in an offering of NASDAQ securities would be exempt from the requirements of the rule. [210] A third example would be to base the *de minimis* exemption in Rule 15c2–6 on transactions in penny stocks, as defined in Rule 3a51–1, rather than transactions in designated securities.

The Commission also is considering amending Rule 15c2–6 to require broker-dealers to distribute a standardized risk disclosure document to customers before effecting the first transaction in securities subject to the rule with or for a customer. The document would resemble the risk disclosure document set forth in proposed Rule 15g–2, but would include a statement regarding the broker-dealer's obligations under Rule 15c2–6.

The Commission believes that conforming Rule 15c2–6 and the penny stock rules would simplify broker-dealer compliance procedures. Accordingly, the Commission requests comment on its plan to amend Rule 15c2–6 to make the rule consistent in appropriate respects with the penny stock rules. Specific language will be proposed for public comment after the Commission receives comments on proposed Rule 3a51–1 and Rules 15g–1 through 15g–7. [211]

V. Conclusion

The Commission is proposing Rule 3a51–1, Rules 15g–1 through 15g–7, and Schedule 15G to implement the directives of the Penny Stock Act. In addition to the comments requested earlier, the Commission solicits comment on the effectiveness of the regulatory scheme set forth above and its effect on the market for penny stocks subject to the rules.

VI. Effects on Competition and regulatory Flexibility Act Considerations

Section 23(a) of the Exchange Act [212] requires that the Commission, in adopting rules under the Exchange Act, consider the anticompetitive effects of such rules, if any, and balance any anticompetitive impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act. The Commission is preliminarily of the view that proposed Rule 3a51–1 and Rules 15g–1 through 15g–7 would not result in any burden on competition that is not necessary or appropriate in

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the Act, is hereby defined to include any representation made to a customer by a broker, dealer or municipal securities dealer who is participating or otherwise financially interested in the primary or secondary distribution of any security which is not admitted to trading on a national securities exchange that such security is being offered to such customer 'at the market' or at a price related to the market price unless such broker, dealer or municipal securities dealer knows or has reasonable grounds to believe that a market for such security exists other than that made, created, or controlled by him, or by any person for whom he is acting or with whom he is associated in such distribution, or by any person controlled by, controlling, or under common control with him."

[206] See, *e.g.*, *SEC* v. *Blinder, Robinson & Co., Inc.*, Litigation Release No. 12539 (July 12, 1990); *SEC* v. *Thomas James Associates, Inc.*, Litigation Release No. 12540 (July 12, 1990).

[207] *Charles Hughes & Co.* v. *SEC*, 139 F.2d 434, 437 (2d Cir 1943), *cert. denied*, 321 U.S. 786 (1943); *Norris & Hirshberg, Inc.*, 21 S.E.C. 865, 881 (1949); *Theodore A. Landau*, 40 S.E.C. 1199, 1126 (1962) *aff'd sub nom, SEC* v. *Scott Taylor & Co.*, 183 F. Supp. 904 (SDNY 1959).

[208] *Shearson, Hammill & Co.*, 42 S.E.C. 811, 823–25 (1965).

[209] For further discussion of the definition of "designated security" and the transactional exemptions provided by paragraph (c) of Rule 15c2–6, see discussion *supra*, at section II of this release.

[210] See the discussion of proposed Rule 15g–1 at Section III.C. of this release.

[211] The amendments to Rule 15c2–6 therefore will reflect any subsequent amendments to the penny stock rules, particularly Rules 3a51–1 and 15g–1.

[212] 15 U.S.C. 78w(a)(2).

implementing the requirements of the Penny Stock Act and otherwise in furtherance of the purposes of the Exchange Act. The Commission requests comment, however, on any competitive burdens that might result from adoption of the rule.

In addition, the Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA"), pursuant to the requirements of the Regulatory Flexibility Act,[213] regarding the proposed rules. The IRFA indicates the proposed rules could impose some additional costs on small broker-dealers and small issuers. The Commission believes, however, that the rules minimize these costs to the greatest extent possible while still fulfilling their purpose under the Penny Stock Act and otherwise under the Exchange Act to prevent fraud. A copy of the IRFA may be obtained from Alexander Dill, Attorney, Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Mail Stop 5–1, Washington, DC 20549, (202) 504–2418.

List of Subjects in 17 CFR Parts 240 and 241

Reporting and recordkeeping requirements, Securities.

VII. Statutory Basis and Text of Amendments

In accordance with the foregoing, the Commission is proposing to amend title 17, chapter II of the Code of Federal Regulations as follows:

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

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

Authority: 15 U.S.C. 77c, 77d, 77s, 78c, 78d, 78i, 78j, 78l, 78m, 78n, 78o, 78p, 78s, 78w, 78x, 79q, 79t, 80a–29, 80a–37, unless otherwise noted.

2. By adding § 240.3a51–1 as follows:

§ 240.3a51–1 Definition of penny stock.

For purposes of section 3(a)(51) of the Act, the term "penny stock" shall mean any equity security other than a security:

(a) That is a reported security, as defined in 17 CFR 240.11Aa3–1(a) of this chapter;

(b) Issued by an investment company registered under the Investment Company Act of 1940;

(c) That is a put or call option issued by the Options Clearing Corporation;

(d) That has a price of five dollars or more, excluding any broker-dealer commission, commission equivalent, mark-up, or mark-down in an agency transaction or a contemporaneous offsetting purchase and sale principal transaction, but including any broker-dealer mark-up or mark-down in any other principal transaction;

(1) For purposes of this paragraph—

(i) a security has a price of five dollars or more for a particular transaction if the security is purchased or sold in that transaction at a price of five dollars or more; and

(ii) other than where a particular transaction is effected, a security has a price of five dollars or more at a given time if: the average of three or more *bona fide* independent interdealer bid quotations at specified prices displayed at that time in an interdealer quotation system, as defined in 17 CFR 240.15c2–7(c)(1), by market makers in the security to which the quotations apply, is five dollars or more; or a bona fide independent bid quotation displayed by a national securities exchange that makes transaction reports available pursuant to 17 CFR 240.11Aa3–1 is five dollars or more.

(2) If a security is a unit composed of one or more securities, the unit price divided by the number of shares of the unit that are not warrants, options, rights, or similar securities must be five dollars or more, as determined in accordance with paragraph (d)(1) of this section, and any share of the unit that is a warrant, option, right, or similar security, or a convertible security, must have an exercise price or conversion price of five dollars or more;

(e) registered, or approved for registration upon notice of issuance, and traded on a national securities exchange that:

(1) makes transaction reports available pursuant to 17 CFR 240.11Aa3–1; and

(2) has maintenance listing criteria that include, as a grounds for delisting a security of an issuer, a minimum $2,000,000 issuer net tangible assets or stockholders' equity standard, either alone, or in conjunction with a net income standard; or

(f) authorized, or approved for authorization upon notice of issuance, for quotation on an automated quotation system that:

(1) is sponsored by a registered securities association;

(2) was established and in operation before January 1, 1990; and

(3) has maintenance qualification criteria that include, as a grounds for terminating the quotation of a security of an issuer, a minimum $2,000,000 issuer net tangible assets or stockholders' equity standard, either alone, or in conjunction with a net income standard.

3. By adding § 240.15g–1 as follows:

§ 240.15g–1 Exemption for certain transactions.

(a) The following transactions shall be exempt from 17 CFR 240.15g–2, 17 CFR 240.15g–3, 17 CFR 240.15g–4, 17 CFR 240.15g–5, and 17 CFR 240.15g–6 of this chapter:

(1) Transactions by a broker or dealer:

(i) Whose commissions, commission equivalents, mark-ups, and mark-downs from transactions in penny stocks during each of the immediately preceding three months, and during eleven or more of the preceding twelve months, did not exceed five percent of its total commissions, commission equivalents, mark-ups, and mark-downs from transactions in securities during those months; and

(ii) Who has not been a market maker in the penny stock that is the subject of the transaction in the immediately preceding twelve months.

(2) Transactions in a penny stock, the issuer of which has net tangible assets in excess of: $2,000,000, if the issuer has been in continuous operation for at least three years; or $5,000,000, if the issuer has been in continuous operation for less than three years.

(i) For purposes of paragraph (a)(2) of this section, net tangible assets must be demonstrated by financial statements dated less than fifteen months prior to the date of the transaction that the broker or dealer has reviewed and has a reasonable basis for believing are accurate in relation to the date of the transaction with the person, and:

(A) If the issuer is other than a foreign private issuer, are 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 17 CFR 210.2–02 of this chapter; or

(B) If the issuer is a foreign private issuer, are the most recent financial statements for the issuer that have been filed with the Commission or furnished to the Commission pursuant to 17 CFR 240.12g3–2(b) of this chapter; provided, however, that if financial statements for the issuer dated less than fifteen months prior to the date of the transaction have not been filed with or furnished to the Commission, financial statements dated within fifteen months prior to the transaction shall be prepared in accordance with generally accepted accounting principles in the country of incorporation, audited in compliance

[213] 5 U.S.C. 603.

with the requirements of that jurisdiction, and reported on by an accountant duly registered and in good standing in accordance with the regulations of that jurisdiction;

(ii) The broker or dealer shall preserve, as part of its records, copies of the financial statements required by paragraph (a)(2)(i) of this section for the period specified in 17 CFR 240.17a–4(b).

(3) Transactions in which the customer is an institutional accredited investor, as defined in 17 CFR 230.501(a)(1), (2), (3), (7) or (8) of this chapter.

(4) Transactions that are not recommended by the broker or dealer.

(5) Transactions in which the purchaser is the issuer of the penny stock that is the subject of the transaction.

(6) Any other transaction or transactions or persons or class of persons that, upon prior written request or upon its own motion, the Commission conditionally or unconditionally exempts by order as consistent with the public interest and the protection of investors.

(b) The following transactions shall be exempt from 17 CFR 240.15g–2, 17 CFR 240.15g–3, and 17 CFR 240.15g–6 of this chapter:

(1) Transactions in a penny stock registered, or approved for registration upon notice of issuance, and that are executed on a national securities exchange that makes transaction reports available pursuant to 17 CFR 240.11Aa3–1 of this chapter.

(2) Transactions in a penny stock authorized, or approved for authorization upon notice of issuance, for quotation in the National Association of Securities Dealers Automated Quotation system (NASDAQ), where the transaction is executed with or by:

(i) A dealer that is registered as a NASDAQ market maker in the penny stock that is the subject of the transaction;

(ii) A broker that is crossing two customer orders as agent; or

(iii) An underwriter or any member of a syndicate or selling group that is participating in a distribution of the penny stock that is the subject of the transaction.

4. By adding 240.15g–2 as follows:

§ 240.15g–2 Risk disclosure document relating to the penny stock market.

It shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless, prior to effecting such transaction, the broker or dealer has furnished to the customer a document containing the information set forth in Schedule 15G, 17 CFR 240.15g–100 of this chapter.

5. By adding 240.15g–3 as follows:

§ 240.15g–3 Broker or dealer disclosure of quotations and other information relating to the penny stock market.

(a) *Requirement.* It shall be unlawful for a broker or dealer to effect a transaction in any penny stock with or for the account of a customer unless such broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the following information:

(1) Except as provided in paragraph (a)(2) of this section, with respect to a transaction effected with or for the account of a customer on a principal basis,

(i) The dealer shall disclose its offer price for the security:

(A) If during the previous five days the dealer consistently has effected *bona fide* sales to other dealers at its offer price for the security current at the time of those sales, and

(B) If the dealer reasonably believes in good faith at the time of the transaction with the customer that its offer price accurately reflects the price at which it is willing to sell one or more round lots to another dealer;

(ii) The dealer shall disclose its bid price for the security:

(A) If during the previous five days the dealer consistently has effected *bona fide* purchases from other dealers at its bid price for the security current at the time of those purchases, and

(B) If the dealer reasonably believes in good faith at the time of the transaction with the customer that its bid price accurately reflects the price at which it is willing to buy one or more round lots from another dealer; (iii)

If the dealer's bid or offer prices to the customer do not satisfy the criteria of paragraphs (a)(1)(i) or (a)(1)(ii) of this section, the dealer shall disclose to the customer:

(A) That it has not consistently effected inter-dealer purchases or sales of the penny stock at its bid or offer price, and

(B) The price at which it last purchased the penny stock from, or sold the penny stock to, respectively, another dealer in a *bona fide* transaction;

(iv) For purposes of this paragraph (a)(1), "consistently" shall constitute, at a minimum, seventy-five percent of the dealer's respective *bona fide* interdealer purchase or sales transactions during the previous five-day period.

(2) With respect to transactions effected by a broker or dealer with or for the account of the customer:

(i) On an agency basis; or

(ii) On a basis other than as a market maker in the security, where, after having received an order from the customer to purchase a penny stock the dealer effects the purchase from another person to offset a contemporaneous sale of the penny stock to such customer, or, after having received an order from the customer to sell the penny stock, the dealer effects the sale to another person to offset a contemporaneous purchase from such customer,

the broker or dealer shall disclose the best independent interdealer bid and offer prices for the penny stock that the broker or dealer obtains through reasonable diligence. A broker-dealer shall be deemed to have exercised reasonable diligence if it obtains quotations from three independent dealers (or all dealers if there are fewer than three).

(3) With respect to bid or offer prices and transaction prices disclosed pursuant to paragraph (a) of this section, the broker or dealer shall disclose the number of shares to which the bid and offer prices apply.

(b) *Timing.* The information described in paragraph (a) of this section:

(1) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(2) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b–10 of this chapter.

(c) *Exemption for Certain Transactions From Pre-Trade Disclosure.* A broker or dealer shall be exempt from the requirements of paragraph (b)(1) of this section if:

(1) The broker or dealer provides the information described in paragraph (a) of this section promptly after effecting a transaction in a penny stock for or with a customer;

(2) At the time the information is provided, the broker or dealer gives the customer, and notifies the customer that the customer has, the unconditional right to cancel the transaction, without monetary penalty, until the end of the business day following the day the customer was provided the information; and

(3) In the written disclosure that the broker or dealer provides to the customer pursuant to paragraph (b)(2) of this section, the broker or dealer notifies the customer of the right of cancellation as specified in paragraph (c)(2) of this section, that the broker or dealer has

provided such right to the customer, orally or in writing, and that the customer has not exercised such right.

(d) *Definitions.* For purposes of this section:

(1) *Bid* shall mean the specified price most recently communicated by the dealer to another broker or dealer at which that dealer is willing to purchase one or more round lots of a penny stock, and shall not include indications of interest;

(2) *Offer* shall mean the specified price most recently communicated by the dealer to another broker or dealer at which that dealer is willing to sell one or more round lots of a penny stock, and shall not include indications of interest.

6. By adding § 240.15g–4 as follows:

§ 240.15g–4 Disclosure of compensation to brokers or dealers.

Preliminary Note: Brokers and dealers may wish to refer to Securities Exchange Act Release No. _____ (date) for a discussion of the procedures for computing compensation in active and competitive markets, inactive and competitive markets, and dominated markets.

(a) *Disclosure Requirement.* It shall be unlawful for any broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless such broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the amount of any compensation received by such broker or dealer in connection with such transaction.

(b) *Timing.* The information described in paragraph (a) of this section:

(1) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(2) Shall again be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b–10 of this chapter.

(c) *Exemption for Certain Transactions from Pre-Trade Disclosure.* A broker or dealer shall be exempt from the requirements of paragraph (b)(1) of this section if:

(1) The broker or dealer provides the information described in paragraph (a) of this section promptly after effecting a transaction in a penny stock for or with a customer;

(2) At the time the information is provided, the broker or dealer gives to the customer, and notifies the customer that the customer has, the unconditional right to cancel the transaction, without monetary penalty, until the end of the business day following the day the customer was provided the information; and

(3) In the written disclosure that the broker or dealer provides to the customer pursuant to paragraph (b)(2) of this section, the broker or dealer again notifies the customer of the right of cancellation as specified in paragraph (c)(2) of this section, that the broker or dealer has provided such right to the customer, orally or in writing, and that the customer has not exercised such right.

(d) *Definition of Compensation.* For purposes of this section, "compensation" means, with respect to a transaction in a penny stock:

(1) If the broker is acting as agent for a customer, the amount of any remuneration received or to be received by it from such customer in connection with such transaction;

(2) If, after having received a buy order from a customer, the dealer purchased the penny stock as principal from another person to offset a contemporaneous sale to such customer or, after having received a sell order from a customer, sold the penny stock as principal to another person to offset a contemporaneous purchase from such customer, the difference between the price to the customer and such contemporaneous purchase or sale price; or

(3) If the dealer is otherwise acting as principal for its own account, the difference between the price to the customer and the prevailing market price.

7. By adding § 240.15g–5 as follows:

§ 240.15g–5 Disclosure of compensation of associated persons in connection with penny stock transactions.

(a) *Requirement.* It shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless such broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the following information with respect to any associated person of the broker or dealer that is a natural person and has communicated with the customer in connection with the transaction:

(1) The aggregate or per share amount of cash compensation that such associated person has received or will receive from any source in connection with the transaction, where such compensation is determined on a transaction or per share basis; and

(2) The amount of cash or other compensation that such associated person has received from any source during the preceding calendar year in connection with transactions in penny stocks, if such amount exceeded 25 percent of the total amount of compensation received by such associated person during such year in connection with transactions in penny stocks and other securities. *Note:* Payments under reciprocal arrangements whereby compensation is directed to associated persons other than the associated person who has communicated with the customer in an attempt to avoid the disclosure requirements of this section will be considered as compensation that is required to be disclosed under this section.

(b) *Timing.* The information described in paragraph (a) of this section:

(1) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(2) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b–10 of this chapter.

(c) *Exemption for Certain Transactions from Pre-Trade Disclosure.* A broker or dealer shall be exempt from the requirements of paragraph (b)(1) of this section if:

(1) The broker or dealer provides the information described in paragraph (a) of this section promptly after effecting a transaction in a penny stock for or with a customer;

(2) At the time the information is provided, the broker or dealer gives to the customer, and notifies the customer that the customer has, the unconditional right to cancel the transaction, without monetary penalty, until the end of the business day following the day the customer was provided the information; and

(3) In the written disclosure that the broker or dealer provides to the customer pursuant to paragraph (b)(2) of this section, the broker or dealer notifies the customer of the right of cancellation as specified in paragraph (c)(2) of this section, that the broker or dealer has provided such right to the customer, orally or in writing, and that the customer has not exercised such right.

8. By adding § 240.15g–6 as follows:

§ 240.15g–6 Account statements for purchasers of penny stocks.

(a) *Requirement.* It shall be unlawful for any broker or dealer that has effected the sale to any customer of any penny stock, or any successor of such

broker or dealer, to fail to give or send to such customer a written statement containing the information described in paragraphs (b) and (c) of this section within ten days following the end of each calendar month in which such penny stock is held for the customer's account with the broker-dealer; *Provided, however,* That

(1) If the broker-dealer does not effect any transactions in penny stocks for or with the account of the customer during a period of six consecutive calendar months, then with respect to each quarterly period subsequent to such six-month period in which the broker-dealer does not effect any transactions in penny stocks for or with the account of the customer, the broker-dealer may provide the statements required hereunder on a quarterly basis, within ten days following the end of each such quarterly period; and

(2) This section shall not apply with respect to any period for which an account statement relating to such penny stock would otherwise be required hereunder if, at the end of such period, transactions in such penny stock would be exempted from this section pursuant to 17 CFR 240.15g–1(a)(2) of this chapter.

(b) *Market and Price Information.* The statement required by paragraph (a) of this section shall contain at least the following information with respect to each penny stock covered by paragraph (a) of this section, as of the last trading day of the period to which the statement relates:

(1) The identity and number of shares or units of each such security held for the customer's account, the date or dates of purchase, and the purchase price paid by the customer, inclusive of any mark-up, commission, or other form of broker-dealer remuneration; and

(2) The estimated market value of the security, to the extent that such estimated market value can be determined in accordance with the following provisions:

(i) If the broker-dealer furnishing the statement has effected at least ten separate Qualifying Purchases in the security during the last five trading days of the period to which the statement relates, the weighted average price per share paid by the broker-dealer in all Qualifying Purchases effected during such five-day period, multiplied by the number of shares or units of the security held for the customer's account; or

(ii) If paragraph (b)(2)(i) of this section is not applicable, and if there are at least three Qualifying Bids for the security during the last five trading days of the period to which the statement relates, the average of all such Qualifying Bids as of the end of each day of such five-day period on which any Qualifying Bids are entered, multiplied by the number of shares or units held for the customer's account; or

(iii) If neither paragraph (b)(2)(i) nor (b)(2)(ii) of this section is applicable, a statement that there is "no estimated market value" with respect to the security.

(c) *Legend.* In addition to the information required by paragraph (b) of this section, the written statement shall include a legend, conspicuously displayed, that is identified with the penny stocks described in the statement and that contains the following language:

The market for these securities may be limited. The broker-dealer furnishing this statement may not refuse to accept your order to sell these securities. However, any estimated market values contained in this statement are based on recent purchases by the broker-dealer furnishing the statement, or on bid prices of other broker-dealers, and this information may not serve as a reliable indicator of the price that the customer could obtain in selling the securities. If estimated market values have not been provided for any securities, such values cannot be determined because sufficient purchase or bid information is not available. These securities are subject to payment of commissions or markdowns if they are sold.

(d) *Preservation of Records.* Any broker or dealer subject to this section shall preserve, as part of its records, copies of the written statements required by paragraph (a) of this section and keep such records for the periods specified in 17 CFR 240.17a–4(b) of this chapter.

(e) *Definitions.* For purposes of this section:

(1) *Qualifying Purchases* shall mean *bona fide* purchases by a broker-dealer of a penny stock for its own account, each of which involves at least 100 shares, but excluding any block purchase involving more than five percent of the outstanding shares or units of the security.

(2) *Qualifying Bids* shall mean *bona fide,* interdealer bid quotations at specified prices entered in an interdealer quotation system, as defined in 17 CFR 240.15c2–7(c) of this chapter, by dealers that are market makers in the security to which the quotations apply and that the broker-dealer furnishing the account statement reasonably believes are acting independently of each other and such broker-dealer.

9. By adding § 240.15g–7 as follows:

§ 240.15g–7 Requirements applicable to penny stock market makers.

(a) *Disclosure requirement.* It shall be unlawful for a broker or dealer that is the sole market maker with respect to any penny stock (other than a dealer that is a specialist on a national securities exchange with respect to such security) or any broker or dealer controlling, controlled by, or under common control with, such broker or dealer ("affiliate"), to effect a transaction in such security for or with the account of a customer, unless it discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the fact that it or its affiliate is the sole market maker with respect to such security and that, by virtue of such status, it or its affiliate exercises substantial influence over the market for the security, or unless it has reasonable grounds to believe that a market for such security exists other than that made, created, or controlled by it or its affiliate; *Provided,* That for purposes of this section the term "customer" shall not include a broker or dealer.

(b) *Timing of disclosure.* The information described in paragraph (a) of this section:

(1) Shall be provided to the customer orally or in writing, prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock, and

(2) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b–10 of this chapter.

(c) *Prohibited representations.* It shall be unlawful for a broker or dealer that is a market maker with respect to any penny stock (other than a dealer that is a specialist on a national securities exchange with respect to such security) or an affiliate of such broker or dealer, in connection with a transaction in such security for or with the account of a customer, to make any representation to the customer that such transaction is being effected "at the market" or at a price related to the market price unless it has reasonable grounds to believe that a market for such security exists other than that made, created, or controlled by it or its affiliate.

10. By adding § 240.15g–100 as follows:

§ 240.15g–100 Schedule 15G—Information to be included in the document distributed pursuant to 17 CFR 240.15g–2.

Securities and Exchange Commission
Washington, DC 20549

Schedule 15G

Under the Securities Exchange Act of 1934

Instructions to Schedule 15G

A. The information contained in Schedule 15G ("Schedule") must be reproduced in its entirety. No language of the document may be omitted, added to, or altered in any way.

B. The disclosures made through this document are in addition to any other disclosure(s) that are required to be made under the federal securities laws, including without limitation the disclosures required pursuant to the rules adopted under Sections 15(c)(1), 15(c)(2), and 15(g) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(c) (1) and (2), and 15 U.S.C. 78o(g), respectively.

C. The format and typeface of the document must be reproduced as presented in the Schedule. The document may be reproduced from the Schedule by photographic copying that is clear, complete, and at least satisfies the type-size requirements set forth below for printing. In the alternative, the document may be printed and must meet the following criteria regarding typeface:

1. Words appearing in capital letters in the Schedule must be reproduced in capital letters and printed in bold-face roman type at least as large as ten-point modern type and at least two points leaded.

2. Words appearing in lower-case letters must be reproduced in lower-case roman type at least as large as ten point modern type and at least two points leaded.

3. Words that are underlined in the document must be underlined in reproduction and appear in bold-faced roman type at least as large as ten point modern type and at least two points leaded, and meet the criteria for lower-case or capital letters in paragraphs (1) and (2) above, whichever is applicable.

D. Recipients of the document must not be charged any fee in connection with the document.

E. The content of the Schedule is as follows:

[next page]

Penny Stock Disclosure Document

This statement is required by the U.S. Securities and Exchange Commission ("Commission"). It contains important information that you should know before you purchase penny stocks.

The securities being sold to you have not been approved or disapproved by the Securities and Exchange Commission. Moreover, the Securities and Exchange Commission has not passed upon the fairness or the merits of this transaction nor upon the accuracy or adequacy of the information contained in any prospectus or any other information provided by an issuer or a broker or dealer.

Generally, a penny stock is an equity security that has the following characteristics:

* it is priced under five dollars;
* it is *not* traded on a national stock exchange;
* it is *not* a security for which there are real-time price and volume reports for each transaction (including most recent sales). Some securities listed or regional exchanges and quoted in NASDAQ, however, fall in this category;
* it may be listed in the "pink sheets";
* it is issued by a company that has less than $5 million in net tangible assets and has been in business less than three years, or by a company that has under $2 million in net tangible assets and has been in business over three years.

Use caution when investing in penny stocks. You should take the following precautions before investing in penny stocks:

1. *Do not make a hurried investment decision.* High-pressure sales techniques can be a warning sign of fraud.

2. *Study the company issuing the stock.* Be wary of companies that have no operating history, few assets, or no defined business purpose. They may be sham or shell companies. Read the prospectus for the company before you invest.

3. *Understand the speculative nature of these stocks.* You should be aware that you may lose part or all of your investment. New companies usually are riskier investments.

4. *Understand all the risks involved.* Be sure that you can afford and are willing to be exposed to such a loss.

5. *Know the brokerage firm and the salespeople with whom you are dealing.* Ask the National Association of Securities Dealers (NASD) or your state securities regulator about the licensing and disciplinary record of the brokerage firm ("broker-dealer") and the sales person contacting you. *A toll-free telephone number is being established* so that you may make this inquiry free of charge.

6. *Make sure you understand how the penny stock market works.* For further information, see below.

Your Rights

Disclosures to you. Under penalty of federal law, your brokerage firm must disclose the following information to you before effecting a penny stock transaction for you and upon confirming that transaction:

* *The bid and offer prices for the penny stock, and the number of shares to which the quoted prices apply.* The bid and offer prices should reflect the price that dealers use when trading the stock among themselves. The inter-dealer price should give you an idea of the fair market value of the stock. If a dealer has not purchased or sold the penny stock at its own bid and offer prices with consistency in the five days prior to the transaction with you, the dealer must disclose that fact to you and must disclose the price at which it last purchased the penny stock from, or sold the penny stock to, another dealer in a *bona fide* transaction. A lack of inter-dealer activity should tell you that the market in the stock is not active and that it may be difficult to resell the stock. You also should be aware that the actual price charged to you for the securities may differ from the price quoted to you for 100 shares. You should therefore determine, before you agree to a purchase, what the actual sales price will be (before the markup) for the exact number of shares you intend to purchase.
* *The markup or commission that the firm will receive as compensation for the transaction with you.* As more fully described below, a markup is the amount a dealer adds to the price of the security in addition to the amount it paid to obtain the security from another dealer or the issuer. A markup is usually intended as an equivalent to a broker's commission on a transaction. A markup is generally calculated from the inter-dealer purchase price, or the offer price to you. Once you learn the markup from the dealer, you should consider that markup in relation to the offer price and determine whether the investment is worthwhile given the dealer's markup charge.
* *The amount and type of compensation that the brokerage firm's salesperson will receive from any source through that transaction with you.* This disclosure must include cash payments and non-cash bonuses, if substantial. The firm must disclose to you, in the aggregate or on a per-share basis, any cash compensation going to the salesperson with whom you are dealing, if the firm makes its calculations on a transactional or per-share basis. The firm also must disclose to you, in the aggregate for the entire preceding calendar year, all cash and non-cash compensation to that salesperson from all of his or her transactions in penny stocks, if that employee did substantial business in penny stocks during such year.

Timing of disclosures to you. Each of these disclosures must be made to you orally or in writing: (1) Before you enter into any contract to purchase or sell penny stock, or (2) after you have entered a contract, only if the broker-dealer then promptly provides the disclosures to you, and if, when making the disclosures, the broker-dealer gives you the unconditional right, until the end of the next business day, to cancel the contract without a monetary penalty to you. The disclosures must also be provided to you in the written confirmation of purchase or sale.

Monthly account statements. In addition to the disclosures noted above, unless you have an account that has been inactive during the past six months, *your brokerage firm must send you a monthly statement* indicating each penny stock held by you, the price you paid, and the market value of each penny stock in your account. If a market value cannot be determined (usually as a result of an inactive market in the stock), your broker must disclose this fact to you.

Legal remedies available to you. If penny stocks are sold to you in violation of the federal securities laws, you may be able to rescind your purchase contract and get your money back. If the stocks are sold in a fraudulent manner, you may be able to sue the source of the fraud for your damages. If you have signed an arbitration agreement, however, you may be required to pursue your claim through arbitration procedures. Because the Commission is not authorized to represent individuals in private litigation, you should contact an attorney in order to pursue a claim that you may have. However, for the protection of yourself and all investors, you should report any perceived violation of the penny stock rules or other securities laws to the Commission, the NASD, or your state

securities administrator. These bodies are empowered to enjoin or otherwise sanction fraudulent and abusive activity of individuals and firms engaged in the securities business. You can contact the Commission or the NASD at the addresses and telephone numbers provided below.

Important Market Information

The penny stock market. Penny stocks tend not to be listed on an exchange or quoted in the NASDAQ system, but rather are traded between dealers on the telephone in the "over-the-counter" market. Often, price information for these securities is not publicly available. Investors in penny stocks may have to rely solely on a broker-dealer to obtain and determine the prices at which they can buy and sell penny stock. In such instances, investors should take extra caution to investigate both the broker-dealer selling the stock and the company issuing the stock to ensure that both are legitimate and that the prices quoted reflect an independent market value.

Market domination. For many penny stocks, there may be only one or two firms dealing in the securities. When there is only one dealer or market maker, or just a few market makers, buying or selling a security, there is a danger that the dealer or group of dealers may control the market in that stock, and, at worst, set prices that are not based on competitive forces. In recent years, some market makers have created artificial markets in certain penny stocks, so that stock prices rose suddenly, but collapsed just as quickly, at a loss to investors. You should ask whether the firm is acting as a broker (your agent) or as a dealer. If the firm is a dealer, ask how many other market makers there are in the security, and attempt to determine whether the firm (or group of firms) dominates the market in the security. A dominated market may result in artificial and arbitrary prices.

Mark-ups and mark-downs. A firm acting as a dealer or market maker in a stock buys and sells the stock for its own account, and may carry an inventory of the stock. When a dealer sells stock to a customer, it adds to the selling price a transaction fee called a "markup." When a dealer purchases from a customer, it subtracts a "markdown" from the bid price. The actual price that the customer pays includes the markup or markdown. Markups and markdowns constitute direct profits for the firm and its salespeople, so an investor should be aware of such amounts to assess the overall value of the trade.

"Bid" and "offer." The bid and offer quotations in a stock are very important information. The offer price is the price at which the dealer is willing to sell you stock. The bid price is the price a dealer is willing to pay for the stock when it purchases from you or another dealer. Find out whether there is both a bid and an offer normally available for the stock. If there is no bid, you may not be able to sell the stock after you buy it, and may suffer a full loss on your purchase.

The "spread." The difference between the bid and offer price is the "spread." Like a markup, the spread is another source of profit for the brokerage firm: the larger the spread, the greater the profit for the firm. A large spread may prove detrimental to an investor. For some penny stocks, the "spread" between the bid and offer may be a significant percentage of the purchase price of the stock. Where the bid price is much lower than the offer price, the market value of the stock must rise substantially before the stock can be sold at a profit. Moreover, an investor may experience substantial losses if the stock must be sold immediately.

Example: If the bid is $0.04 per share and the offer is $0.10 per share, the spread (difference) is $0.06, which appears to be a small amount. But you would lose $0.06 on every share that you bought for $0.10 if you had to sell that stock immediately to the same firm. If you had invested $5,000 at the $0.10 offer price, the market maker's repurchase price, at $0.04 bid, would be only $2,000; thus you would lose $3,000, or more than half of your investment, if you decided to sell the stock. In addition, you would have to pay transaction fees to buy and sell the stock.

Primary offerings. Although most penny stocks are sold to the public through aftermarket trading (that is, the trading that occurs on an ongoing basis after the completion of an initial public offering), occasionally dealers will sell these stocks in initial public offerings ("IPOs"). Special attention should be paid to IPOs of low-priced securities because the market for these securities is untested. Because the offering is on a first-time basis, there is generally no market information about the securities that would allow assessment of their true value. The federal securities laws generally require broker-dealers to provide investors with a prospectus containing information about the objectives, management, and financial condition of the issuer. In the absence of market information, investors should read the company's prospectus with special care to assess whether the securities are a worthwhile investment.

Warning: You have the right to sell a security that you have purchased or own. If a broker-dealer or its representative tells you that you cannot sell your stock, or if the broker-dealer or its representative refuses to take your order to sell your stock, you should consider reporting such activity to your state securities administrator, or to the Commission or the NASD at the addresses provided below, and you should consider seeking legal counsel.

For more information about penny stocks, contact the Office of Filings, Information, and Consumer Services of the U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549, (202) 272-7440, or the NASD, 1735 K Street, NW., Washington, DC 20006 (202) 728-8000.

PART 241—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

Part 241 of title 17 of the Code of Federal regulations is amended by adding section III. F. of this Release "Statement by the Commission on Disclosure of Compensation of Broker or Dealers in Penny Stocks" to the list of interpretive releases set forth thereunder.

By the Commission.

Dated: April 17, 1991.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 91-9414 Filed 4-24-91; 8:45 am]

BILLING CODE 8010-01-M

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17 CFR Parts 230 and 240

[Release No. 33-6891; 34-29096; File No. S7-10-91]

RIN 3235-AD54

Blank Check Offerings

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rules.

SUMMARY: To implement provisions of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, the Commission today is publishing for comment proposed rules relating to registration statements filed by blank check companies offering penny stock, including requirements to deposit in a special account securities issued and funds received in the offering, restrict trading in deposited securities, disclose information regarding acquisitions by the blank check company, provide purchasers with the right to obtain a refund of deposited funds upon receipt of the information, and require the return of deposited funds to the investors if an acquisition meeting specified criteria have not been made within 18 months after the initial offering date.

DATES: Comments should be received on or before July 19, 1991.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth St., NW., Washington, DC 20549. Comments should refer to File No. S7-10-91. All comments received will be available for public inspection and copying in the Commission's Public Reference Room at the same address.

FOR FURTHER INFORMATION CONTACT: Richard P. Konrath, Office of Disclosure Policy, Division of Corporation Finance, Securities and Exchange Commission, 450 Fifth St., NW., Washington, DC 20549, (202) 272-2589.

SUPPLEMENTARY INFORMATION: The Commission is publishing for comment proposed new Rule 419 under the Securities Act of 1933 ("Securities