

**Securities Industry Association**

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March 27, 1998

Joan Conley
Office of the Corporate Secretary
National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500

Re: NASD NTMs 98-14 and 98-15

Dear Ms. Conley:

The Federal Regulation Committee and the Self-Regulation Committee ("the Committees") of the Securities Industry Association ("SIA")¹ appreciate the opportunity to submit this comment letter in response to NASD Notices to Members 98-14 and 98-15 ("NTMs"), regarding proposed amendments to Rule 6530 and proposed new rules 2315, 2350 and 6540.

According to the two NTMs, the proposed changes are intended to address "abuses in the trading and sales of thinly traded, thinly capitalized (microcap) securities" and "actual and potential fraud or manipulation in the markets for these securities." As discussed below, the Committees believe that, while the proposals seek to achieve laudable goals, in some respects they sweep more broadly than appears necessary or appropriate. The rules would cover many significant issuers including companies of substantial size for which any logical concern about "microcap fraud" is hard to perceive. Closely analogous regulatory concerns about potential wrongdoing in the penny stock market resulted in prophylactic rules that are geared toward the thinly capitalized issuers that are the apparent source of the concerns. We believe that the same policy considerations that limited the penny stock rules to issuers below specified asset size or market capitalization, or to broker-dealers whose commissions from penny stocks exceeded five per cent of total commissions, apply here as well.

In particular, proposed new rules 2315 and 2350, in their current form, would have adverse consequences that have little to do with concerns about battling microcap fraud. They would create significant new regulatory uncertainties and costs for legitimate broker-dealers, discouraging law-abiding broker-dealers from making markets in OTC securities. At the same time, the promoters and boiler-room operators that are the source of the NASD's concern will simply flout new regulatory requirements the same way that they flout existing requirements.

Moreover, the growth of the Internet increases the likelihood that, as liquidity in regulated OTC markets shrinks, much of that trading may migrate to entirely unregulated environments. In contrast, the proposed amendments to Rule 6530 and proposed new Rule 6540, while arguably broader than necessary, are more focused responses to the NASD's concerns because they set out "bright line" tests that do not impose such significant new regulatory costs on responsible broker-dealers.

The SEC recently proposed its own package of rule changes designed to address its identical concerns with microcap fraud. The Committees recommend that the NASD should extend its comment period, and delay further action on its rule proposal, until the SEC has the opportunity to complete action on its proposals. While the SEC's rules, as currently drafted, use many identical or nearly identical terms as the NASD's proposals, it is impossible to know at this time what changes the SEC might make to its proposal if it adopts final rules. The Committees recommend that the NASD wait to see what final action the SEC takes before moving ahead with its own initiative.

Proposed New Rules 2315 and 2350.

General Concerns. Although NTM 98-15 indicates that proposed Rules 2315 and 2350 are proposed as a means to combat abuses in microcap stocks, the rules appear to reach much farther than those concerns warrant. While the NASD's discussion does not define the term "microcap," it does set forth the marketplace in which these rules would apply. These markets encompass a vast range of securities, including a great many for which the term "microcap," as it is commonly understood, as well as concerns about manipulation and other abuses, are inapplicable. For example, over-the-counter ("OTC") securities that are encompassed in the NASD's proposed rules include American Depositary Receipts ("ADRs") of approximately 900 foreign issuers.² These include ADRs for securities of 24 companies with global market capitalization exceeding \$20 *billion* each, including Novartis, Roche Holdings, Nestle, Sumitomo Bank, Siemens and L'Oreal, with global market capitalizations of \$104 billion, \$86 billion, \$54 billion, \$47 billion, \$37 billion and \$27 billion respectively. ³ In addition, while most U.S. issuers traded on OTC markets are relatively small unregulated companies, the list is very diverse, and includes nearly 50 issuers with a market capitalization of over \$100 million, ⁴ as well as a large number of small and regional banks that are subject to regulatory scrutiny. Efforts to eradicate manipulative schemes involving thinly capitalized and little-known issuers, while praiseworthy, should not unduly hamper the market for companies as to which these concerns do not apply.

In adopting rules to address serious regulatory concerns about abuses in the penny stock market, the SEC created special disclosure rules for penny stocks, but also created several exemptions based on the size of the issuer or the extent to which a broker-dealer depends on revenues generated by penny stock transactions.⁵ While the Committees oppose proposed rules 2315 and 2350 and believe that they suffer from many deficiencies that are discussed below, if the NASD believes that some additional regulation is necessary, it should issue a proposal that is more limited in scope in a manner consistent with the SEC's penny stock rules.

Proposed Rule 2315. Rule 2315 would apply to "recommendations" to customers regarding equity securities that are "published or quoted in a quotation medium" but are not listed on a U.S. securities exchange or traded on Nasdaq. For securities covered by the rule, the broker-dealer must review "reasonably current financial statements" of the issuer, and ensure

that these financial statements "and other available information provides a reasonable basis under the circumstances" for the recommendation.

Each of the words quoted in the preceding paragraph is open to extremely broad interpretation:

- The term "recommendation" is not defined in the Rule, but has been very broadly applied in other contexts.⁶
- The phrase "published or quoted in a quotation medium" as defined would pick up both U.S. and foreign quotation services.
- The phrase "and other available information provides a reasonable basis under the circumstances" could be read as an expansion of the doctrine of suitability. In addition, that phrase is potentially in conflict with the NASD's institutional suitability interpretation.⁷
- There is a lack of clarity about the meaning of "financial statements of the issuer . . . and other information available," which are to be the source of the broker-dealer's "reasonable basis" for making a recommendation. For example, under what circumstances must a broker-dealer consult other "available" information? If an issuer's financial statements are unaudited, what if any additional steps should the broker-dealer must take beyond review of the financials? Is there an implicit qualification that the information be *reasonably* available? To what lengths would a broker-dealer have to go to determine what "other information" is "available"?

These ambiguities, taken both singly and in combination, will create significant uncertainties and create significant compliance costs in many instances. The result is likely to be that many legitimate broker-dealers, concerned about the expanded scope and vague nature of their compliance obligations in this area, will cease to recommend OTC securities. Given the uncertainties as to what constitutes a "recommendation," in many instances a decision not to "recommend" a security is almost tantamount to a decision not to engage in any transactions with customers in that security. This in turn will further reduce liquidity for this large segment of the capital market, a result that would not be helpful to investors, and that could, ironically, create more opportunities for abuses.

Aside from our concern about the impact of Rule 2315 on all OTC securities, the Committees have a particular concern about the breadth of the term "reasonably current" as applied to foreign issuers. As defined, that term creates a presumption that, in situations where the issuer's balance sheet is six months or older, it must be accompanied by additional profit-and-loss statements for the period from the date of the balance sheet to a date less than six months prior to the date of the recommendation. This approach creates serious impediments for recommendations of foreign issuers' equity securities or ADRs traded in OTC markets. Many nations, such as the United Kingdom and Germany, permit their domestic issuers to report financial information on a semi-annual rather than a quarterly basis. Read literally, the NASD rule would bar recommendations of OTC equity securities of most issuers from such nations during the periods when no financial information less than six months old is publicly available. The regulatory burden and impairment of liquidity that would result from broker-dealers refraining from recommending such securities during these periods seems hardly justified by any concern about microcap fraud. Indeed, the adverse impact that this approach is likely to have on investor opportunities to access foreign equity securities seems

more compelling than any concern that, absent this measure, perpetrators of microcap stock fraud will become active in the ADR market.

NTM 98-15 invited specific comment on "whether both the member firm and its registered representative must perform the review required by the proposed rule, or whether it would be sufficient if either the firm or the representative making the recommendation conducted the review." The Committees believe that, if the NASD determines to pursue proposed Rule 2315 as proposed or in some narrower form that is consistent with the scope of the SEC's Penny Stock rules, the Rule should clarify that any due diligence review required prior to a recommendation can be made either by a broker-dealer or by the representative making the review.⁸ This is appropriate for two reasons. First, as NTM 98-15 notes, the proposed rule would place an increased burden on retail firms, and it seems appropriate to let firms decide for themselves how that burden should be met. Second, since both the firm and the individual representative making a recommendation would be potentially liable for a violation of the proposed rule, each will have an interest in ensuring that the review is done as a matter of course.

In addition to permitting a firm and its representative to decide among themselves who is responsible for the review, the Committees urge that broker-dealers be permitted to "piggy-back" on the due diligence of another broker-dealer, so long as proper disclosure is made, such as through a quotation indicator, so that customers know which broker-dealer has reviewed the required financial information. Those OTC securities that are recommended by several broker-dealers are less likely to be vehicles for microcap abuses, and relieving some of those broker-dealers of a redundant due diligence responsibility seems desirable to ensure continued liquidity for the security.

Proposed Rule 2350. The Committees also have significant concerns about proposed Rule 2350, which would require broker-dealers to furnish customers with a disclosure statement before effecting the customer's first purchase of an equity security covered by the rule, and that the customer manually sign and date a written acknowledgment of receipt of the statement. While the penny stock rules exempt transactions with established customers from similar pre-transaction disclosure delivery requirements⁹, this rule has no such exemption. The time delays and administrative burdens of such written pre-approval are likely to greatly discourage broker-dealers and their customers from engaging in transactions covered by the proposed rule, thereby impairing liquidity. These costs, while they would be significant in any event, are exacerbated by the proposed rule's proscription against obtaining a customer's acknowledgment through secure electronic media. In addition, the rule as written appears to have an unlimited global reach, covering transactions in the United States or abroad in OTC foreign stocks.

The regulatory justification for proposed Rule 2350 is very hard to discern, particularly with regard to OTC issuers such as banks or large foreign issuers. It seems highly inappropriate to lump these issuers together with the thinly capitalized and unregulated companies that are the source of the NASD's legitimate concerns about microcap securities fraud. This result seems particularly unwarranted, given that there are a number of less severe ways of reaching the NASD's objective. The NASD's proposed amendment to Rule 6530 and proposed new rule 6540, discussed below, offer a less drastic response to its concern about microcap fraud. In addition, the NASD could consider less restrictive measures, such as written procedures

regarding suitability determinations when recommending thinly capitalized OTC securities, that would more precisely address its regulatory concern with less likelihood of unnecessary collateral damage to market liquidity.

Amendments to Rule 6530 and Proposed New Rule 6540.

The proposed amendment to Rule 6530 would limit quotations on the OTC Bulletin Board to issuers that currently file their reports with the SEC or other regulatory authorities, while proposed Rule 6540 would prohibit a member from quoting a security on the OTC Bulletin Board unless the issuer has made current filings. Amended Rule 6530 and new Rule 6540 create a direct listing requirement for the OTC Bulletin Board. These proposals set out a much clearer allocation of responsibilities to broker-dealers than does proposed Rule 2315.

Like proposed rule 2315 and 2350, proposed rules 6530 and 6540 sweep more broadly than necessary. These rules would be more appropriately focused if they applied only to securities of issuers with assets or market capitalization below a certain threshold. In addition, as suggested in the Committees' comments above on proposed rule 2315, it would be desirable if the NASD clarified that a broker-dealer can meet its obligations under Rules 6530 and 6540 if it relies on a security's principal market-maker's due diligence, and discloses this through an indicator in its quote. Despite these suggestions for improvement, the Committees believe that the general approach taken in proposed rules 6530 and 6540 is a more appropriate regulatory response to the problem of abuses in the microcap market, and is the wiser course for the NASD to pursue.

Conclusion.

Thank you for providing the Committees with the opportunity to comment on the rule proposals in NTM 98-14 and 98-15. The Committees fully share the NASD's concern with eradicating fraud and abusive practices involving microcap securities. As discussed above, we believe that proposed rules 2315 and 2350 will not advance that goal, but that the proposed amendment to Rule 6530 and proposed Rule 6540 could be helpful, particularly with the modifications that we suggest. We hope that the comments offered above will help the NASD to shape an approach that addresses this concern without unnecessarily impeding liquidity or investment opportunities. If we can be of further assistance, please do not hesitate to contact the undersigned, or George Kramer at 202/296-9410.

Sincerely,

Lee B. Spencer, Jr.,
Chairman
Federal Regulation Committee

R. Gerald Baker,
Chairman
Self-Regulation Committee

cc: Sara Nelson Bloom, Associate General Counsel, The Nasdaq Stock Market
David Spotts, Senior Attorney, NASD Regulation

Footnotes:

¹ The Securities Industry Association is the trade association representing more than 780 securities firms headquartered throughout North America. Its members include securities organizations of all types: investment banks, brokers, dealers, specialists, and mutual fund companies. SIA members are active in all markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of investment services and account for approximately 90% of the securities industry's revenue in the United States.

² Data provided by the Bank of New York.

³ Financial Times (January 22, 1998), FT 500 Insert.

⁴ See Walker's Manual of Unlisted Stocks, 2d ed. (1997). These companies literally include the "kitchen sink" -- a major manufacturer of plumbing products (Kohler Co.), as well as a world leader in map publication (Rand McNally).

⁵ For example, the SEC excluded from the enhanced requirements, among other things: (i) securities of issuers with net tangible assets in excess of \$2,000,000 (or \$5,000,000 if the issuer has been in continuous operation for less than three years); (ii) securities of issuers with average revenue of at least \$6,000,000 for the previous three years; (iii) transactions by a broker-dealer whose revenues derived from transactions in penny stocks during specified periods did not exceed five per-cent of its overall transaction-based revenue, or that has not been a market-maker in the penny stock that is the subject of the transaction for at least 12 months; or (iv) transactions with institutional accredited investors. See Exchange Act Rules 3a51-1(g)(1) and (2) and 15g-1. In addition, Exchange Act Rule 15g-9 exempts transactions with "established customers" from a disclosure requirement that closely resembles proposed Rule 2350, except that 2350 offers no similar exemption.

⁶ Because the term "recommendation" is susceptible to very broad after-the-fact construction, for compliance purposes many retail and institutional transactions that are very likely unsolicited are nevertheless treated by broker-dealers as though they were recommended.

⁷ 61 Fed. Reg. 44100 (Aug. 27, 1996), SEC Release No. 34-37588. Broker-dealers already have an obligation to have "reasonable grounds" for recommendations to customers under NASD Conduct Rule 2310. Since neither the proposed rule nor the proposing release cross-refer to that rule, it is not clear if the rule is intended to simply restate this existing obligation, with its existing gloss of interpretation by the NASD, other regulators and the courts, or to formulate a new, and very inchoate, regulatory obligation.

⁸ Furthermore, with respect to non-U.S. securities, the Committees believe that a broker-dealer should be able to rely on a review conducted by a financial services affiliate who has expertise in the relevant market or issuer. In this regard, the appropriate standard should be reasonable reliance, rather than Series 7 registration.

⁹ Exchange Act Rule 15g-9(c)(3).