

January 11, 2002

Katherine A. England
Assistant Director
Division of Market Regulation
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-99-04**
Microcap Initiative - Recommendation Rule; Response to Comments and
Amendment No. 1

Dear Ms. England:

In this letter, NASD Regulation, Inc. (“NASD Regulation”) responds to the comment letters received by the U.S. Securities and Exchange Commission (“Commission” or “SEC”) in response to the publication in the Federal Register of Notice of Filing of SR-NASD-99-04.¹ This Notice addressed a microcap initiative proposed by NASD Regulation to govern recommended transactions in over-the-counter (“OTC”) equity securities. Further, NASD Regulation submits Amendment No. 1 to this filing, with proposed rule language. Attached as Exhibit 1 is a draft Notice to facilitate publication of the proposed amendments in the Federal Register, together with a 3-1/2” disk containing Exhibit 1 saved on Microsoft Word 7.0.

Background

NASD Regulation has been concerned with abuses in the trading and sales of thinly traded, thinly capitalized (“microcap”) securities quoted in the OTC market, and in particular, with the connection between potential fraud and manipulation and the lack of reliable and current financial information about issuers of microcap securities. NASD Regulation proposed to amend National Association of Securities Dealers, Inc. (“NASD”) rules to include new NASD Rule 2315, entitled “Recommendations to Customers in OTC Equity Securities” (“Recommendation Rule”). As described in the rule filing and in this amendment, the Recommendation Rule requires a member, before it recommends a transaction in an OTC equity security, to review certain financial and business information and determine that there is a reasonable basis for making the recommendation. The proposed rule also provides certain exemptions from the rule’s requirements.

¹ Exchange Act Release No. 41075, 64 Fed. Reg. 10037 (March 1, 1999). The public comment period announced in the Federal Register expired on March 22, 1999.

The requirements of the Recommendation Rule are in addition to other existing member obligations under NASD rules and the federal securities laws, including obligations to determine suitability of particular securities transactions for customers and to have a reasonable basis for any recommendation made to a customer. The rule is not intended to act or operate as a presumption or as a safe harbor for purposes of determining suitability or for any other legal obligation or requirement imposed under NASD rules or the federal securities laws.

The Recommendation Rule is one of the NASD's microcap initiatives that was originally published for comment in NASD Notice to Members 98-15 in January 1998. In May 1998, the NASD Board of Governors and NASD Regulation Board of Directors approved certain modifications, and at its meeting in December 1998, the NASD Board approved additional changes.

On March 1, 1999, the SEC published the Recommendation Rule for public comment in the Federal Register. The Commission specifically sought comment on the potential need for exemption from proposed Rule 2315.

The Commission received six comment letters in response to the Federal Register publication. The comment letters were from Goldman, Sachs & Co. ("Goldman"); A.G. Edwards & Sons, Inc. ("Edwards"); National Quotation Bureau ("NQB"); Securities Industry Association ("SIA"); Enstar Group, Inc. ("Enstar"); and Sullivan & Cromwell ("S&C").

After considering the comments, NASD Regulation has made changes to the proposed Recommendation Rule. The text of the proposed rule provided in Amendment No. 1 reflects these changes, which include revised definitions, modified review requirements, and additional and revised exemption provisions. NASD Regulation is filing the amendment notwithstanding that the SEC has not acted on repropoed Exchange Act Rule 15c2-11. To ensure more consistency, NASD Regulation originally had intended to await action on repropoed Rule 15c2-11 before filing the amendment. NASD Regulation will consider whether further revisions are required to this proposal following SEC action on repropoed Rule 15c2-11.

Issues Raised in Comment Letters

The commenters generally supported the concept behind the microcap initiative, that is, as a regulator, NASD Regulation should continue to combat fraud, manipulation and other abuses in the sale of microcap securities. The comments were directed primarily at modifying and clarifying the language in the proposed rule. Absent changes, a number of the commenters believed that the rule would impose an inappropriate burden on competition.

Application of the Rule

Proposed Rule 2315, as published in the Federal Register, would apply when a member or associated person recommends to a customer the purchase, sale or exchange of any OTC equity security. Two commenters, Edwards and S&C, asked that the rule define the term “recommendation.” Edwards believed the definition should distinguish a “recommendation” from a “solicitation,” while S&C was concerned whether a research report with a “buy” recommendation would constitute a “recommendation” under the proposed rule. NASD Regulation believes that it is not necessary to define the term “recommendation” in this rule. For guidance, members are directed to NASD Rule 2310 “Recommendations to Customers (Suitability)” and the accompanying interpretive material. Further, NASD Notices to Members provide supplemental advice regarding questions relating to suitable recommendations.²

Edwards, the SIA and the NQB proposed that “sales” be eliminated from the requirement of the rule, arguing that there should not be any potential regulatory barrier to allowing a broker to recommend, for example, that a client sell a security from what the broker may suspect is a “pump-and-dump” scheme. NASD Regulation agrees that the regulatory benefits of this rule apply to recommendations to purchase or sell short, but not to recommendations to sell. Therefore, it has revised the requirement by deleting the requirement that the rule apply to recommendations to sell or exchange a security and adding the requirement that the rule apply to recommendations to sell short.

The rule applies to any equity security that is not listed on Nasdaq or on a national securities exchange and is published or quoted in a quotation medium. The SIA and Goldman stated that the rule should apply only when the member has actual knowledge that the security is published or quoted in a quotation medium. NASD Regulation, concerned about possible circumvention of the rule, does not agree that the rule should apply only when the member has actual knowledge that the security is being published or quoted.

Definitions

Several commenters, Edwards, Goldman, SIA and S&C, offered changes to the definition of “current financial statements” in the proposed Recommendation Rule. They argued that the definition did not take into account the customary accounting periods of foreign issuers. For example, Goldman noted that many nations, such as the United Kingdom and Germany, permit their domestic issuers to report financial information on a semi-annual basis rather than on a

² See NASD Notice to Members 01-23, “Suitability Rule and Online Communications (April 2001); NASD Notice to Members – For Your Information, “Clarification of Notice to Members 96-60” (March 1997); NASD Notice to Members 96-60, “Clarification of Members’ Suitability Responsibilities under NASD Rules with Special Emphasis on Member Activities in Speculative and Low-Priced Securities” (September 1996); and NASD Notice to Members 96-32, “Members Reminded to Use Best Practices When Dealing in Speculative Securities” (May 1996).

quarterly basis. Several commenters recommended that the definition be harmonized with that in repropoed Rule 15c2-11,³ which distinguishes between the foreign private issuers and non-foreign private issuers. NASD Regulation agrees with this suggestions and has revised the definition to be consistent with the language in repropoed Rule 15c2-11 for non-reporting companies,⁴ including foreign private issuers. The term “foreign private issuer” is defined in Rule 3b-4 promulgated under the Securities Exchange Act of 1934.

Edwards, Goldman, the SIA and S&C criticized the requirement in the Recommendation Rule that firms review financial statements and other financial reports filed with “any regulatory authority” as being overly broad. The SIA, for example, pointed out that these financial reports could include an endless array of filings, such as tax filings, filings with trade authorities and even filings with environmental or labor authorities. As to foreign issuers, commenters recommended that the rule be limited to filings made by the issuer with the principal securities regulator in its home jurisdiction, rather than “any regulatory authority.” NASD Regulation has revised the requirement in response to the comments.

Further, the definition of “current financial statements” included, among other things, all financial information provided in offerings made pursuant to Rule 505 or Rule 506 of Regulation D. The same four commenters requested that this requirement be eliminated, pointing out that the offering materials are not publicly available. NASD Regulation has removed from the definition of “current financial statements” financial information provided in offerings made pursuant to Rules 505 and 506. However, the requirement that a broker review certain financial information prior to making a recommendation would clearly apply to the secondary trading of covered securities that were originally offered pursuant to any small or private offering exemption, including Rule 505 or Rule 506.

Finally, NASD Regulation notes that current financial statements must be prepared in accordance with generally accepted accounting principles (GAAP) or foreign GAAP. If the financial statements are not audited, the issuer must provide a representation that the financial statements are prepared in accordance with GAAP or foreign GAAP.

The Recommendation Rule also defined the term “quotation medium.” Edwards argued that the rule should apply only to priced quotations, while the NQB suggested that the rule apply to all non-Nasdaq equity securities, as that term is defined in the Rule 6700 Series. The SIA suggested that the definition of “quotation medium” be limited to those that give priced quotations; and it recommended that the definition mirror the language in repropoed Rule 15c2-

³ Publication or Submission of Quotations Without Specified Information, Repropoed Rule, 64 Fed. Reg. 11124 (March 8, 1999).

⁴ Id. at 11144.

11. NASD Regulation does not believe it should narrow the rule to include only priced quotations, nor does it believe it should expand the rule so broadly as to encompass all non-Nasdaq equity securities, including those not published or quoted in a quotation medium. However, it has determined to revise the definition of “quotation medium” to be consistent with that in repropoed Rule 15c2-11.⁵

Requirements

NASD Regulation received comments on several areas relating to the Recommendation Rule’s requirements. First, S&C expressed concern that the proposed rule would, in effect, add a new suitability requirement that would apply in addition to the suitability requirement in NASD Rule 2310. S&C suggested that NASD Regulation modify the rule to focus on a member’s need to be “familiar” with the security and the issuer. As stated in the “Preliminary Note” to the proposed rule, the requirements of the Recommendation Rule are clearly in addition to existing obligations, including obligations to determine suitability. NASD Regulation believes that the Recommendation Rule is necessary to address abuses in the trading and sales of microcap securities, and in light of the exemptions, applies appropriately.

Second, as originally proposed, Rule 2315 required members to review current business information about an issuer. Edwards and the SIA expressed concern that the requirement was too broad and could conceivably include almost any fact or rumor published by anyone in periodicals or in sites on the Internet. In response, NASD Regulation has changed the requirement so that member need review only current material business information about the issuer. Generally, current material business information would include that material information that is available or relates to events that have occurred within the last twelve months prior to the recommendation.

Third, the proposed Recommendation Rule required that a registered person conduct the review of the financial and business information. Goldman and the SIA expressed concern that it was too restrictive to limit this function to registered persons. However, NASD Regulation maintains that the review should be conducted by a registered person over whom it has jurisdiction; it has not made changes to this requirement. NASD Regulation also requires that the member document the information reviewed, the date of the review and the name of the person who conducted the review.

Finally, NASD Regulation received comments on the requirement that members conduct an inquiry when an issuer has not made current filings. Goldman suggested that the provision be

⁵ NASD has slightly modified the definition found in repropoed Rule 15c2-11 to expressly include dissemination of indications of interest. However, this change remains consistent with repropoed Rule 15c2-11 because that rule incorporates indications of interest through its definition of “quotation.” NASD Regulation’s proposed Recommendation Rule does not contain a separate definition of “quotation.”

strengthened to say that no recommendation can be made if the filings are delinquent. The SIA and S&C stated that the reference to “any regulatory authority” was too broad, and that it should be changed to the “issuer’s principal financial or securities regulatory authority in its home jurisdiction.” NASD Regulation does not agree that the rule should unilaterally prohibit a recommendation if the issuer is delinquent in its filing. However, it has narrowed the reference from “any regulatory authority” to “issuer’s principal financial or securities regulatory authority in its home jurisdiction” which is consistent with the change to the definition of “current financial statements.”

Exemptions

NASD Regulation amended the exemption provisions of the Recommendation Rule in several ways. First, in response to comments by S&C, NASD Regulation added “qualified institutional buyers” as defined under Rule 144A to the list of customers for whom the rule would not apply.

Second, commenters recommended changes to the exemption for large issuers, that is, issuers with \$100 million in assets and \$10 million in shareholder’s equity. Goldman and the SIA recommended reducing the asset threshold to \$25 million in assets, while Enstar recommended changing the test to a net tangible asset test found in repropoed Rule 15c2-11. NASD Regulation recognizes that the asset amount could be reduced without significantly diminishing the effectiveness of the rule, although it believes that a reduction to \$50 million in assets is sufficient. Also, the exemption was revised to refer to the revised definition of “current financial statements” so as to address comments regarding the age of the balance sheets in the original proposed Recommendation Rule.

Third, in response to comments by Edwards, Goldman, the SIA and S&C, two new exemptions were added to ensure that the rule focused on small issuers, where the microcap abuses have been found. NASD Regulation determined that it was appropriate to include exemptions that were consistent with those provided in repropoed Rule 15c2-11. Thus, NASD Regulation added provisions to exempt a security based on the security’s average daily trading volume (“ADTV”) value and the security’s bid price. Specifically, an exemption applies to a security with a worldwide ADTV value of at least \$100,000 during each month of the six full calendar months immediately before the date of the recommendation; the exemption also covers a convertible security, if the underlying security meets the ADTV value requirement. An exemption also applies when a security has a bid price of at least \$50 per share, as published in a quotation medium.

Finally, in response to comments by the NQB, NASD Regulation has provided that members may seek an exemption for good cause shown, pursuant to the Rule 9600 Series. The

exemption may be for any person, security or transaction, or for certain classes of persons, securities or transactions, such as securities listed on certain foreign exchanges.

However, NASD Regulation did not adopt two further proposals for exemptions. Goldman and the SIA suggested that the rule not apply to members that are also investment advisers, and to members that are subject to Rule 472 “Communications with the Public” of the New York Stock Exchange (“NYSE”). NASD Regulation believes that the provisions of Rule 472 do not have the specificity of the Recommendation Rule and thus, the Recommendation Rule is appropriately applied to NASD members that are also NYSE members. NASD Regulation does not agree that the rule should have an exemption for members that are also investment advisers.

Amended Rule Language

2315. Recommendations to Customers in OTC Equity Securities

Preliminary Note: The requirements of this Rule are in addition to other existing member obligations under NASD rules and the federal securities laws, including obligations to determine suitability of particular securities transactions with customers and to have a reasonable basis for any recommendation made to a customer. This Rule is not intended to act or operate as a presumption or as a safe harbor for purposes of determining suitability or for any other legal obligation or requirement imposed under NASD rules or the federal securities laws.

(a) Review Requirement

[(1)] No member or person associated with a member shall recommend [to a customer the purchase, sale, or exchange of] that a customer purchase or sell short any equity security that is not listed on Nasdaq or on a national securities exchange and is published or quoted in a quotation medium unless the member has reviewed the current financial statements of [,] the issuer, [and] current material business information about [,] the issuer, and [makes] made a determination that such information, and any other information available, provides a reasonable basis under the circumstances for making the recommendation.

(b) Definitions

(1) For purposes of this Rule, the term “current financial statements” shall include:

(A) For issuers that are not foreign private issuers,

(i) a balance sheet as of a date less than [16] 15 months before the date of the recommendation;

(ii) a statement of profit and loss for the 12 months preceding the date of the balance sheet;

(iii) if the balance sheet is not as of a date less than 6 months before the date of the recommendation, additional statements of profit and loss for the period from the date of the balance sheet to a date less than 6 months before the date of the recommendation;

(iv) publicly available financial statements and other financial reports filed during the 12 months preceding the date of the recommendation and up to the date of the recommendation with [any] the issuer's principal financial or securities regulatory authority in its home jurisdiction, including the Commission, foreign regulatory authorities, bank and insurance regulators; and

(v) all publicly available financial information [contained in registration statements, including any amendments, with respect to securities transactions registered under the Securities Act of 1933 (Securities Act), or in the case of securities offered pursuant to the exemptions from registration provided by Regulation A, Rule 505, or Rule 506 under the Securities Act, all financial information provided in connection with offerings conducted pursuant to those rules] filed with the Commission during the 12 months preceding the date of the recommendation contained in registration statements or Regulation A filings.

(B) For foreign private issuers,

(i) a balance sheet as of a date less than 18 months before the date of the recommendation;

(ii) a statement of profit and loss for the 12 months preceding the date of the balance sheet;

(iii) if the balance sheet is not as of a date less than 9 months before the date of the recommendation, additional statements of profit and

loss for the period from the date of the balance sheet to a date less than 9 months before the date of the recommendation, if any such statements have been prepared by the issuer; and

(iv) publicly available financial statements and other financial reports filed during the 12 months preceding the date of the recommendation and up to the date of the recommendation with the issuer's principal financial or securities regulatory authority in its home jurisdiction, including the Commission, foreign regulatory authorities, bank and insurance regulators.

(2) For purposes of this Rule, the term "quotation medium" shall mean any [quotation system, publication, electronic communication network, or any other device, including any issuer or inter-dealer quotation system, that is used to regularly disseminate quotations or indications of interest in transactions in equity securities that are not listed on Nasdaq or on a national securities exchange, including offers to buy or sell at a stated price or otherwise or invitations of offers to buy or sell]:

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

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

(c) Compliance Requirements

(1) A member [firm] shall designate a registered [individual] person to conduct the review required by this R[r]ule. In making such designation, the member [firm] must ensure that:

(A) E[e]ither the [individual] person is registered as a Series 24 principal, or [his] the person's conduct in complying with the provisions of this Rule is appropriately supervised by a Series 24 [individual] principal; and

(B) S[s]uch designated [individual] person has the requisite skills, background and knowledge to conduct the review required under this R[r]ule.

(2) The member shall document the information reviewed, the date of the review, and the name of the person performing the review of the required information.

(d) Additional Review Requirement for Delinquent Filers

If an issuer has not made current filings required by [any] the issuer's principal financial or securities regulatory authority in its home jurisdiction, including the Commission, [a] foreign regulatory [authority] authorities, or bank and insurance regulators, such review must include an inquiry into the circumstances concerning the failure to make current filings, and a determination, based on all the facts and circumstances, that the recommendation is appropriate under the circumstances. Such a determination must be made in writing and maintained by the member.

(e) Exemptions

(1) The requirements of this Rule shall not apply to:

(A) [1] T[t]ransactions that meet the requirements of Rule 504 of Regulation D under the Securities Act of 1933 ("Securities Act") and transactions with an issuer not involving any public offering pursuant to Section 4(2) of the Securities Act;

(B) [2] T[t]ransactions with or for an account that qualifies as an "institutional account" under Rule 3110(c)(4) or with a customer that is a "qualified institutional buyer" under Rule 144A promulgated under the Securities Act or "qualified purchaser" under Section [3(c)(7)] 2(a)(51) of the Investment Company Act of 1940;

(C) [3] T[t]ransactions in an issuer's securities if the issuer has [\$100] at least \$50 million in total assets and \$10 million in shareholder's equity as [of date of the issuer's most recent audited balance sheet, which balance sheet should be of a date within 6 months prior to the recommendation] stated in the issuer's most recent audited current financial statements, as defined in this Rule;

(D) [4] T[t]ransactions in securities of a bank [under] as defined in Section 3(a)(4) (6) of the Securities Exchange Act of 1934 and/or insurance company subject to regulation by a state or federal bank or insurance regulatory authority [.];

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

(F) A convertible security, if the underlying security meets the requirement of Section (e)(1)(E) of this Rule;

(G) A security that has a bid price, as published in a quotation medium, of at least \$50 per share. If the security is a unit composed of one or more securities, the bid price of the unit divided by the number of shares of the unit that are not warrants, options, rights, or similar securities must be at least \$50; or

(2) Pursuant to the Rule 9600 Series, the Association, for good cause shown after taking into consideration all relevant factors, may exempt any person, security or transaction, or any class or classes of persons, securities or transactions, either unconditionally or on specified terms, from any or all of the requirements of this Rule if it determines that such exemption is consistent with the purpose of this Rule, the protection of investors, and the public interest.

* * *

9600. PROCEDURES FOR EXEMPTIONS

9610. Application

(a) Where to File

A member seeking exemptive relief as permitted under Rules 1021, 1070, 2210, 2315, 2320, 2340, 2520, 2710, 2720, 2810, 2850, 2851, 2860, Interpretive Material 2860-1, 3010(b)(2), 3020, 3210, 3230, 3350, 8211, 8212, 8213, 11870, or 11900, Interpretive Material 2110-1, or Municipal Securities Rulemaking Board Rule G-37 shall file a written application with the appropriate department or staff of the Association and provide a copy of the application to the Office of General Counsel of NASD Regulation.

(b) - (c) no change.

* * *

In conclusion, NASD Regulation believes that the proposed Recommendation Rule balances two public interests: protecting investors and ensuring that excessive regulatory burdens

Katherine A. England, Esq.
January 11, 2002
Page 12

are not placed on member firms. Accordingly, NASD Regulation continues to believe that the proposal is an appropriate and reasonable resolution of the issues.

Very truly yours,

Patrice M. Gliniecki
Vice President and
Acting General Counsel

Attachment

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-99-04)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Microcap Initiative - Recommendation Rule

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on , the National Association of Securities Dealers, Inc. (“NASD” or “Association”), through its wholly owned subsidiary, NASD Regulation, Inc. (“NASD Regulation”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing to amend the rules of the Association to add a new rule, Rule 2315. Below is the text of the proposed new rule, as filed with the Commission on January 13, 1999 and as modified by Amendment No. 1. Proposed additions under Amendment No. 1 are in italics; proposed deletions are in brackets.

* * *

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

2315. Recommendations to Customers in OTC Equity Securities

Preliminary Note: The requirements of this Rule are in addition to other existing member obligations under NASD rules and the federal securities laws, including obligations to determine suitability of particular securities transactions with customers and to have a reasonable basis for any recommendation made to a customer. This Rule is not intended to act or operate as a presumption or as a safe harbor for purposes of determining suitability or for any other legal obligation or requirement imposed under NASD rules or the federal securities laws.

(a) Review Requirement

[(1)] No member or person associated with a member shall recommend [to a customer the purchase, sale, or exchange of] that a customer purchase or sell short any equity security that is not listed on Nasdaq or on a national securities exchange and is published or quoted in a quotation medium unless the member has reviewed the current financial statements of [,] the issuer, [and] current material business information about [,] the issuer, and [makes] made a determination that such information, and any other information available, provides a reasonable basis under the circumstances for making the recommendation.

(b) Definitions

(1) For purposes of this Rule, the term “current financial statements” shall include:

(A) For issuers who are not foreign private issuers,

(i) a balance sheet as of a date less than [16] 15 months before the date of the recommendation;

(ii) a statement of profit and loss for the 12 months preceding the date of the balance sheet;

(iii) if the balance sheet is not as of a date less than 6 months before the date of the recommendation, additional statements of profit and loss for the period from the date of the balance sheet to a date less than 6 months before the date of the recommendation;

(iv) publicly available financial statements and other financial reports filed during the 12 months preceding the date of the recommendation and up to the date of the recommendation with [any] the issuer's principal financial or securities regulatory authority in its home jurisdiction, including the Commission, foreign regulatory authorities, bank and insurance regulators; and

(v) all publicly available financial information [contained in registration statements, including any amendments, with respect to securities transactions registered under the Securities Act of 1933 (Securities Act), or in the case of securities offered pursuant to the exemptions from registration provided by Regulation A, Rule 505, or Rule 506 under the Securities Act, all financial information provided in connection with offerings conducted pursuant to those rules] filed with the Commission during the 12 months preceding the date of the recommendation contained in registration statements or Regulation A filings.

(B) For foreign private issuers,

(i) a balance sheet as of a date less than 18 months before the date of the recommendation;

(ii) a statement of profit and loss for the 12 months preceding the date of the balance sheet;

(iii) if the balance sheet is not as of a date less than 9 months before the date of the recommendation, additional statements of profit and loss for the period from the date of the balance sheet to a date less than 9 months before the date of the recommendation, if any such statements have been prepared by the issuer; and

(iv) publicly available financial statements and other financial reports filed during the 12 months preceding the date of the recommendation and up to the date of the recommendation with the issuer's principal financial or securities regulatory authority in its home jurisdiction, including the Commission, foreign regulatory authorities, bank and insurance regulators.

(2) For purposes of this Rule, the term "quotation medium" shall mean any [quotation system, publication, electronic communication network, or any other device, including any issuer or inter-dealer quotation system, that is used to regularly disseminate quotations or indications of interest in transactions in equity securities that are not listed on Nasdaq or on a national securities exchange, including offers to buy or sell at a stated price or otherwise or invitations of offers to buy or sell]:

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

or

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

(c) Compliance Requirements

(1) A member [firm] shall designate a registered [individual] person to conduct the review required by this R[r]ule. In making such designation, the member [firm] must ensure that:

(A) E[e]ither the [individual] person is registered as a Series 24 principal, or [his] the person's conduct in complying with the provisions of this Rule is appropriately supervised by a Series 24 [individual] principal; and

(B) S[s]uch designated [individual] person has the requisite skills, background and knowledge to conduct the review required under this R[r]ule.

(2) The member shall document the information reviewed, the date of the review, and the name of the person performing the review of the required information.

(d) Additional Review Requirement for Delinquent Filers

If an issuer has not made current filings required by [any] the issuer's principal financial or securities regulatory authority in its home jurisdiction, including the Commission, [a] foreign regulatory [authority] authorities, or bank and insurance regulators, such review must include an inquiry into the circumstances concerning the failure to make current filings, and a determination, based on all the facts and circumstances, that the recommendation is appropriate under the circumstances. Such a determination must be made in writing and maintained by the member.

(e) Exemptions

(1) The requirements of this Rule shall not apply to:

(A) [1] T[t]ransactions that meet the requirements of Rule 504 of Regulation D under the Securities Act of 1933 (“Securities Act”) and transactions with an issuer not involving any public offering pursuant to Section 4(2) of the Securities Act;

(B) [2] T[t]ransactions with or for an account that qualifies as an “institutional account” under Rule 3110(c)(4) or with a customer that is a “qualified institutional buyer” under Rule 144A promulgated under the Securities Act or “qualified purchaser” under Section [3(c)(7)] 2(a)(51) of the Investment Company Act of 1940;

(C) [3] T[t]ransactions in an issuer’s securities if the issuer has [\$100] at least \$50 million in total assets and \$10 million in shareholder’s equity as [of date of the issuer’s most recent audited balance sheet, which balance sheet should be of a date within 6 months prior to the recommendation] stated in the issuer’s most recent audited current financial statements, as defined in this Rule;

(D) [4] T[t]ransactions in securities of a bank [under] as defined in Section 3(a)[(4)] (6) of the Securities Exchange Act of 1934 and/or insurance company subject to regulation by a state or federal bank or insurance regulatory authority [.];

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

(F) A convertible security, if the underlying security meets the requirement of Section (e)(1)(E) of this Rule;

(G) A security that has a bid price, as published in a quotation medium, of at least \$50 per share.

If the security is a unit composed of one or more securities, the bid price of the unit divided by the number of shares of the unit that are not warrants, options, rights, or similar securities must be at least \$50; or

(2) Pursuant to the Rule 9600 Series, the Association, for good cause shown after taking into consideration all relevant factors, may exempt any person, security or transaction, or any class or classes of persons, securities or transactions, either unconditionally or on specified terms, from any or all of the requirements of this Rule if it determines that such exemption is consistent with the purpose of this Rule, the protection of investors, and the public interest.

* * *

9600. PROCEDURES FOR EXEMPTIONS

9610. Application

(a) Where to File

A member seeking exemptive relief as permitted under Rules 1021, 1070, 2210, 2315, 2320, 2340, 2520, 2710, 2720, 2810, 2850, 2851, 2860, Interpretive Material 2860-1, 3010(b)(2), 3020, 3210, 3230, 3350, 8211, 8212, 8213, 11870, or 11900, Interpretive Material 2110-1, or Municipal Securities Rulemaking Board Rule G-37 shall file a written application with the appropriate department or staff of the Association and provide a copy of the application to the Office of General Counsel of NASD Regulation.

(b) - (c) no change.

* * *

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. **Purpose**

Background

NASD Regulation has been concerned with abuses in the trading and sales of thinly traded, thinly capitalized (“microcap”) securities quoted in the OTC market, and in particular, with the connection between potential fraud and manipulation and the lack of reliable and current financial information about issuers of microcap securities. NASD Regulation proposed to amend National Association of Securities Dealers, Inc. (“NASD”) rules to include new NASD Rule 2315, entitled “Recommendations to Customers in OTC Equity Securities” (“Recommendation Rule”). As described in the rule filing and in this amendment, the Recommendation Rule requires a member, before it recommends a transaction in an OTC equity security, to review certain financial and business information and determine that there is a reasonable basis for making the recommendation. The proposed rule also provides certain exemptions from the rule’s requirements.

The requirements of the Recommendation Rule are in addition to other existing member obligations under NASD rules and the federal securities laws, including obligations to determine suitability of particular securities transactions for customers and to have a reasonable basis for any recommendation made to a customer. The rule is not intended to act or operate as a presumption or as a safe harbor for purposes of determining suitability or for any other legal obligation or requirement imposed under NASD rules or the federal securities laws.

The Recommendation Rule is one of the NASD's microcap initiatives that was originally published for comment in NASD Notice to Members 98-15 in January 1998. In May 1998, the NASD Board of Governors and NASD Regulation Board of Directors approved certain modifications, and at its meeting in December 1998, the NASD Board approved additional changes.

On March 1, 1999, the SEC published the Recommendation Rule for public comment in the Federal Register. The Commission specifically sought comment on the potential need for exemption from proposed Rule 2315. NASD Regulation is filing the amendment notwithstanding that the SEC has not acted on repropoed Exchange Act Rule 15c2-11. To ensure more consistency, NASD Regulation originally had intended to await action on repropoed Rule 15c2-11 before filing the amendment. NASD Regulation will consider whether further revisions are required to this proposal following SEC action on repropoed Rule 15c2-11.

The Commission received six comment letters in response to the Federal Register publication. The comment letters were from Goldman, Sachs & Co. ("Goldman"); A.G. Edwards & Sons, Inc. ("Edwards"); National Quotation Bureau ("NQB"); Securities Industry Association ("SIA"); Enstar Group, Inc. ("Enstar"); and Sullivan & Cromwell ("S&C").

After considering the comments, NASD Regulation has made changes to the proposed Recommendation Rule. The text of the proposed rule provided in Amendment No. 1 reflects these changes, which include revised definitions, modified review requirements, and additional and revised exemption provisions.

Issues Raised in Comment Letters

The commenters generally supported the concept behind the microcap initiative, that is, as a regulator, NASD Regulation should continue to combat fraud, manipulation and other abuses in the sale of microcap securities. The comments were directed primarily at modifying and clarifying the language in the proposed rule. Absent changes, a number of the commenters believed that the rule would impose an inappropriate burden on competition.

Application of the Rule

Proposed Rule 2315, as published in the Federal Register, would apply when a member or associated person recommends to a customer the purchase, sale or exchange of any OTC equity security. Two commenters, Edwards and S&C, asked that the rule define the term “recommendation.” Edwards believed the definition should distinguish a “recommendation” from a “solicitation,” while S&C was concerned whether a research report with a “buy” recommendation would constitute a “recommendation” under the proposed rule. NASD Regulation believes that it is not necessary to define the term “recommendation” in this rule. For guidance, members are directed to NASD Rule 2310 “Recommendations to Customers

(Suitability)” and the accompanying interpretive material. Further, NASD Notices to Members provide supplemental advice regarding questions relating to suitable recommendations.³

Edwards, the SIA and the NQB proposed that “sales” be eliminated from the requirement of the rule, arguing that there should not be any potential regulatory barrier to allowing a broker to recommend, for example, that a client sell a security from what the broker may suspect is a “pump-and-dump” scheme. NASD Regulation agrees that the regulatory benefits of this rule apply to recommendations to purchase or sell short, but not to recommendations to sell. Therefore, it has revised the requirement by deleting the requirement that the rule apply to recommendations to sell or exchange a security and adding the requirement that the rule apply to recommendations to sell short.

The rule applies to any equity security that is not listed on Nasdaq or on a national securities exchange and is published or quoted in a quotation medium. The SIA and Goldman stated that the rule should apply only when the member has actual knowledge that the security is published or quoted in a quotation medium. NASD Regulation, concerned about possible circumvention of the rule, does not agree that the rule should apply only when the member has actual knowledge that the security is being published or quoted.

Definitions

Several commenters, Edwards, Goldman, SIA and S&C, offered changes to the definition of “current financial statements” in the proposed Recommendation Rule. They argued that the

³ See NASD Notice to Members 01-23, “Suitability and Online Communications” (April 2001); NASD Notice to Members – For Your Information, “Clarification of Notice to Members 96-60” (March 1997); NASD Notice to Members 96-60, “Clarification of Members’ Suitability Responsibilities under NASD Rules with Special Emphasis on Member Activities in Speculative and Low-Priced Securities” (September 1996); and NASD Notice to Members 96-32, “Members Reminded to Use Best Practices When Dealing in Speculative Securities” (May 1996).

definition did not take into account the customary accounting periods of foreign issuers. For example, Goldman noted that many nations, such as the United Kingdom and Germany, permit their domestic issuers to report financial information on a semi-annual basis rather than on a quarterly basis. Several commenters recommended that the definition be harmonized with that in repropose Rule 15c2-11,⁴ which distinguishes between the foreign private issuers and non-foreign private issuers. NASD Regulation agrees with this suggestions and has revised the definition to be consistent with the language in repropose Rule 15c2-11 for non-reporting companies,⁵ including foreign private issuers. The term “foreign private issuer” is defined in Rule 3b-4 promulgated under the Securities Exchange Act of 1934.

Edwards, Goldman, the SIA and S&C criticized the requirement in the Recommendation Rule that firms review financial statements and other financial reports filed with “any regulatory authority” as being overly broad. The SIA, for example, pointed out that these financial reports could include an endless array of filings, such as tax filings, filings with trade authorities and even filings with environmental or labor authorities. As to foreign issuers, commenters recommended that the rule be limited to filings made by the issuer with the principal securities regulator in its home jurisdiction, rather than “any regulatory authority.” NASD Regulation has revised the requirement in response to the comments.

Further, the definition of “current financial statements” included, among other things, all financial information provided in offerings made pursuant to Rule 505 or Rule 506 of Regulation D. The same four commenters requested that this requirement be eliminated, pointing out that the offering materials are not publicly available. NASD Regulation has removed from the

⁴ Publication or Submission of Quotations Without Specified Information, Repropose Rule, 64 Fed. Reg. 11124 (March 8, 1999).

definition of “current financial statements” financial information provided in offerings made pursuant to Rules 505 and 506. However, the requirement that a broker review certain financial information prior to making a recommendation would clearly apply to the secondary trading of covered securities that were originally offered pursuant to any small or private offering exemption, including Rule 505 or Rule 506.

Finally, NASD Regulation notes that current financial statements must be prepared in accordance with generally accepted accounting principles (GAAP) or foreign GAAP. If the financial statements are not audited, the issuer must provide a representation that the financial statements are prepared in accordance with GAAP or foreign GAAP.

The Recommendation Rule also defined the term “quotation medium.” Edwards argued that the rule should apply only to priced quotations, while the NQB suggested that the rule apply to all non-Nasdaq equity securities, as that term is defined in the Rule 6700 Series. The SIA suggested that the definition of “quotation medium” be limited to those that give priced quotations; and it recommended that the definition mirror the language in repropoed Rule 15c2-11. NASD Regulation does not believe it should narrow the rule to include only priced quotations, nor does it believe it should expand the rule so broadly as to encompass all non-Nasdaq equity securities, including those not published or quoted in a quotation medium. However, it has determined to revise the definition of “quotation medium” to be consistent with that in repropoed Rule 15c2-11.⁶

⁵ Id. at 11144.

⁶ NASD has slightly modified the definition found in repropoed Rule 15c2-11 to expressly include dissemination of indications of interest. However, this change remains consistent with repropoed Rule 15c2-11 because that rule incorporates indications of interest through its definition of “quotation.” NASD Regulation’s proposed Recommendation Rule does not contain a separate definition of “quotation.”

Requirements

NASD Regulation received comments on several areas relating to the Recommendation Rule's requirements. First, S&C expressed concern that the proposed rule would, in effect, add a new suitability requirement that would apply in addition to the suitability requirement in NASD Rule 2310. S&C suggested that NASD Regulation modify the rule to focus on a member's need to be "familiar" with the security and the issuer. As stated in the "Preliminary Note" to the proposed rule, the requirements of the Recommendation Rule are clearly in addition to existing obligations, including obligations to determine suitability. NASD Regulation believes that the Recommendation Rule is necessary to address abuses in the trading and sales of microcap securities, and in light of the exemptions, applies appropriately.

Second, as originally proposed, Rule 2315 required members to review current business information about an issuer. Edwards and the SIA expressed concern that the requirement was too broad and could conceivably include almost any fact or rumor published by anyone in periodicals or in sites on the Internet. In response, NASD Regulation has changed the requirement so that member need review only current material business information about the issuer. Generally, current material business information would include that material information that is available or relates to events that have occurred within the last twelve months prior to the recommendation.

Third, the proposed Recommendation Rule required that a registered person conduct the review of the financial and business information. Goldman and the SIA expressed concern that it was too restrictive to limit this function to registered persons. However, NASD Regulation maintains that the review should be conducted by a registered person over whom it has jurisdiction; it has not made changes to this requirement. NASD Regulation also requires that

the member document the information reviewed, the date of the review and the name of the person who conducted the review.

Finally, NASD Regulation received comments on the requirement that members conduct an inquiry when an issuer has not made current filings. Goldman suggested that the provision be strengthened to say that no recommendation can be made if the filings are delinquent. The SIA and S&C stated that the reference to “any regulatory authority” was too broad, and that it should be changed to the “issuer’s principal financial or securities regulatory authority in its home jurisdiction.” NASD Regulation does not agree that the rule should unilaterally prohibit a recommendation if the issuer is delinquent in its filing. However, it has narrowed the reference from “any regulatory authority” to “issuer’s principal financial or securities regulatory authority in its home jurisdiction” which is consistent with the change to the definition of “current financial statements.”

Exemptions

NASD Regulation amended the exemption provisions of the Recommendation Rule in several ways. First, in response to comments by S&C, NASD Regulation added “qualified institutional buyers” as defined under Rule 144A to the list of customers for whom the rule would not apply.

Second, commenters recommended changes to the exemption for large issuers, that is, issuers with \$100 million in assets and \$10 million in shareholder’s equity. Goldman and the SIA recommended reducing the asset threshold to \$25 million in assets, while Enstar recommended changing the test to a net tangible asset test found in repropoed Rule 15c2-11. NASD Regulation recognizes that the asset amount could be reduced without significantly diminishing the effectiveness of the rule, although it believes that an reduction to \$50 million in

assets is sufficient. Also, the exemption was revised to refer to the revised definition of “current financial statements” so as to address comments regarding the age of the balance sheets in the original proposed Recommendation Rule.

Third, in response to comments by Edwards, Goldman, the SIA and S&C, two new exemptions were added to ensure that the rule focused on small issuers, where the microcap abuses have been found. NASD Regulation determined that it was appropriate to include exemptions which were consistent with those provided in repropoed Rule 15c2-11. Thus, NASD Regulation added provisions to exempt a security based on the security’s average daily trading volume (“ADTV”) and the security’s bid price. Specifically, an exemption applies to a security with a worldwide ADTV value of at least \$100,000 during each month of the six full calendar months immediately before the date of the recommendation; the exemption also covers a convertible security, if the underlying security meets the ADTV requirement. An exemption also applies when a security has a bid price of at least \$50 per share, as published in a quotation medium.

Finally, in response to comments by the NQB, NASD Regulation has provided that members may seek an exemption for good cause shown, pursuant to the Rule 9600 series. The exemption may be for any person, security or transaction, or for certain classes of persons, securities or transactions, such as securities listed on certain foreign exchanges.

However, NASD Regulation did not adopt two further proposals for exemptions. Goldman and the SIA suggested that the rule not apply to members who are also investment advisers, and to members who are subject to Rule 472 “Communications with the Public” of the New York Stock Exchange (“NYSE”). NASD Regulation believes that the provisions of Rule 472 do not have the specificity of the Recommendation Rule and thus, the Recommendation Rule is

appropriately applied to NASD members who are also NYSE members. NASD Regulation does not agree that the rule should have an exemption for members who are also investment advisers.

2. **Statutory Basis**

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The NASD believes that the proposed rule change will address actual and potential frauds in the quotation and trading of unlisted securities.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

On March 1, 1999, the Commission published the Association's proposal and solicited comments in the Federal Register. The comment period ended on March 22, 1999. The Commission received six comment letters. After considering the comments, the Association is proposing Amendment No. 1 to the rule filing, as outlined above.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds

such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- A. by order approve such proposed rule change, or
- B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary