

January 13, 1999

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Mail Stop 10-1

Re: **File No. SR-NASD-99-4**
Microcap Initiative - Proposed Recommendation Rule

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed herewith is the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Mary N. Revell, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8203; e-mail Revellm@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Joan C. Conley
Secretary

Attachment

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 ("Act"), NASD Regulation, Inc. ("NASD Regulation") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to adopt new National Association of Securities Dealers, Inc. ("NASD" or "Association") Rule 2315, which requires members to review current issuer information prior to recommending a transaction to a customer in an over-the-counter ("OTC") equity security. Additionally, the proposed rule change would amend NASD Rule 6740 to permit members to submit a certification to the Association that states that the member has conducted a review of specified information and has fulfilled its SEC Rule 15c2-11 obligations for documents that currently reside on the SEC's Electronic Data Gathering and Retrieval System ("EDGAR") database. Below is the text of the proposed rule change. Proposed new language is underlined.

* * *

2315. Recommendations to Customers in OTC Equity Securities

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) (1) No member or person associated with a member shall recommend to a customer the purchase, sale, or exchange of 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 current financial statements of, and current business information about, the issuer, and makes a determination that such information, and any other information available, provides a reasonable basis under the circumstances for making the recommendation.

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

(A) a balance sheet as of a date less than 16 months before the date of the recommendation;

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

(C) 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;

(D) 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 regulatory authority, including the Commission, foreign regulatory authorities, bank and insurance regulators; and

(E) all 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.

(b) If an issuer has not made current filings required by any regulatory authority, including the Commission, a foreign regulatory authority, or bank and insurance regulators, such review must include 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.

(c) For purposes of this Rule, “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.

(d) A member firm shall designate a registered individual to conduct the review required by this rule. In making such designation, the member firm must ensure that

(1) either the individual is registered as a Series 24 principal, or his conduct in complying with the provisions of this Rule is appropriately supervised by a Series 24 individual; and

(2) such designated individual has the requisite skills, background and knowledge to conduct the review required under this rule.

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

(1) transactions that meet the requirements of Rule 504 of Regulation D under the Securities Act and transactions with an issuer not involving any public offering pursuant to Section 4(2) of the Securities Act;

(2) transactions with or for an account that qualifies as an “institutional account” under Rule 3110(c)(4) or with a customer that is a “qualified purchaser” under Section 3(c)(7) of the Investment Company Act;

(3) transactions in an issuer’s securities if the issuer has \$100 million in 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; or

(4) transactions in securities of a bank under Section 3(a)(4) of the Securities Exchange Act of 1934 and or insurance company subject to regulation by a state or federal bank or insurance regulatory authority.

* * *

6740. Submission of Rule 15c2-11 Information on Non-Nasdaq Securities

(a) - (d) No change

(e) As an alternative to submitting to the Association a copy of the documents required by paragraph (b) of the Rule, a member may submit to the Association a certification signed by a principal of the member firm stating that the firm has complied with the requirements of SEC Rule 15c2-11, including the member’s affirmative review obligation, as to any submission with respect to which the required documents currently reside in the SEC’s EDGAR database.

* * *

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meetings on May 6, 1998 and December 9, 1998, which authorized the filing of the rule change with the SEC. The Nasdaq Stock Market (“Nasdaq”) has been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries. The NASD Board of Governors reviewed and approved the proposed rule change at its meetings on May 7, 1998 and December 10, 1998. No other action by the NASD is necessary for the filing of the proposed rule change. Section 1(a)(ii) of Article VII of the By-Laws permits the NASD Board of Governors to adopt NASD Rules and amendments to NASD Rules without recourse to the membership for approval.¹

The NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Mary N. Revell, Associate General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8203.

¹ In May, 1998, the NASD and NASD Regulation Boards also approved the filing with the SEC of a proposed rule change that would require members to provide certain disclosure information on the trade confirmation for customer transactions in an OTC equity security (proposed Rule 2360). A proposed rule change was filed with the SEC on July 17, 1998 containing both proposed Rule 2315 and proposed Rule 2360 (File No. SR-NASD-98-50). In December, 1998, the NASD and NASD Regulation Boards approved withdrawal of proposed Rule 2360 and amendments to proposed Rule 2315. File No. SR-NASD-98-50 was withdrawn on January 13, 1998. This proposed rule change replaces File No. SR-NASD-98-50.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

The NASD has actively studied the OTC market in an effort to address the abuses in the trading and sales of thinly traded, thinly capitalized (microcap) securities. These securities are not listed on Nasdaq or any exchange and trade on the OTC Bulletin Board (“OTCBB”),² in the “pink sheets” published by the National Quotation Bureau, Inc. (“Pink Sheets”), and in other quotation media where there are no listing requirements. The NASD is concerned with actual and potential fraud or manipulation in the markets for these securities, and the connection between potential fraud and manipulation and the lack of reliable and current financial information about issuers of microcap securities.

In the listed securities markets, the quoted price of a security helps to reflect the information available about the listed security and its issuer. In the OTC market, which is less liquid and less transparent, there is a greater need for firms to independently review financial statements to verify that a recommended transaction in a microcap security is suitable. This proposal is meant to address this issue.

Proposed Rule 2315 – Recommendation Rule

Proposed Rule 2315 (“Recommendation Rule”) would prohibit a member or associated person from recommending a transaction to a customer in an OTC equity security that is published or quoted regularly in a quotation medium unless the member has first reviewed

² The OTCBB is a quotation service that displays real-time quotes, last sale prices, and volume information in domestic and certain foreign securities. Eligible securities include national, regional, and foreign equity issues, warrants, units, and American Depositary Receipts (ADRs) not listed on any other U.S. national securities market or exchange. Unlike Nasdaq or registered national securities exchanges where individual companies apply for listing on the market--and must meet and maintain strict listing and maintenance standards--individual brokerage firms, or market makers, enter quotations for specific securities on their own behalf through the OTCBB.

current financial statements and other business information about an issuer and determined that this information, along with other information available, provides a reasonable basis for making the recommendation. Application of the rule would be limited to equity securities that are not listed on Nasdaq or any exchange, and that are quoted on the OTCBB, in the Pink Sheets, or in any other system that regularly disseminates indications of interest and quotation information. Such systems would include Web sites, issuer trading services, and other non-member systems that provide this data to the public.

The requirements in the proposed rule would not affect requirements under the federal securities laws and under NASD rules requiring a broker/dealer that recommends securities to its customers to have a reasonable basis for those recommendations.³ In addition, the proposed rule expressly 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 proposed rule requires members to obtain and review the issuer's "current financial statements" as defined in paragraph (a)(2) of the proposed rule. Specifically, members would be required to obtain and review an issuer's balance sheet that is dated within 16 months of the date of the recommendation, a profit and loss statement for the period of 12 months preceding the date of the balance sheet, and financial statements filed during the 12 months preceding the date of the recommendation.

³ See, e.g., *SEC v. Hasho*, 784 F. Supp. 1059 (S.D.N.Y. 1992), citing *SEC v. Hanley*, 415 F. 2d 589 (2nd Cir. 1969); Securities Exchange Act Release No. 29094 (April 17, 1991), 56 FR 19148 (April 25, 1991) (adopting amendments to Rule 15c2-11), n.22; and NASD Rule 2310 (Suitability Rule), which requires a member to have reasonable grounds for believing that a recommendation to a customer is suitable based on facts disclosed, other security holdings, and financial situation and needs.

Under circumstances in which a proposed recommendation to the customer is not made within six months of the date of the issuer's balance sheet, the member would be required to obtain and review an additional profit and loss statement of the issuer from the date of the balance sheet to a date within six months of the proposed recommendation to the customer.⁴ For example, if a member proposes to make a recommendation to a customer on March 15, 1999, the member would be required to obtain and review the following information to satisfy the proposed rule: a balance sheet of the issuer with a calendar year-end of December 31, 1997; a profit and loss statement for the 12-month period ended December 31, 1997; and a nine-month interim profit and loss statement for the period of January 1, 1998, through at least September 30, 1998.

When issuers file reports with the SEC or with other foreign or domestic regulatory authorities, the proposed rule would require members to collect and review all financial statements and other financial reports filed by the issuer within the twelve months preceding the recommendation. Members also must obtain and review financial information contained in registration statements of registered securities and all financial information provided in connection with securities offered pursuant to an exemption from registration.

If an issuer has not made current filings as required by a regulatory authority, a member must inquire into the circumstances concerning the issuer's failure to file current reports and determine based on all the facts and circumstances whether a recommendation is appropriate under the circumstances. The evidence of the determination to make a recommendation in this situation should be in writing and maintained by the member.

⁴ This requirement is similar to language in paragraph (a)(5) of SEC Rule 15c2-11, which governs the initiation or resumption of quotations for non-reporting issuers. SEC Rule 15c2-11 requires a broker/dealer to collect

The proposed rule requires a member to designate a registered individual to conduct a review of the information specified in paragraph (a)(2) of the proposed rule. In making this determination, a member firm must ensure that either the individual is registered as a Series 24 principal, or his conduct in complying with the provisions of this proposed rule is appropriately supervised by a Series 24 individual. The designated individual should possess the requisite skills, background, and knowledge to conduct the review required by the proposed rule. The associated person making the recommendation to the customer is obligated, prior to the recommendation, to assure that the member has conducted such a review of the specified information in accord with the proposed rule. The member should document the list of information reviewed, the date of the review, and the name of the person performing the review of the required information under the proposed rule.

Exemptions

The proposed rule exempts from its coverage transactions that are exempt from registration under Section 4(2) of the Securities Act and transactions that meet the requirements of Rule 504 of Securities Act Regulation D. This exemption is based on the fact that, unlike the specific disclosure requirements that apply to registered and other offerings, the Securities Act does not mandate that Section 4(2) and Rule 504 issuers furnish specified information to purchasers. Hence, there is no specific information to review. The exemption also is based on the reduced manipulative potential associated with private offerings.

Because of this exemption, there are no specific review requirements under the proposed Recommendation Rule for broker/dealers that recommend transactions in securities exempt from registration under Rule 504 or Section 4(2) of the Securities Act. However, under prevailing

and review certain information before initiating or resuming quotations in a quotation medium. See Securities

law, including SEC Rule 10b-5 and NASD Rule 2310, a broker/dealer must have a reasonable basis for recommending a securities transaction to a customer and must make an appropriate suitability determination. In order to satisfy these requirements with respect to Rule 504 or Section 4(2) exempt offerings, the broker/dealer must review any information provided by the issuer as well as other relevant information, including information obtained in response to “red flags” and otherwise. Broker/dealers that recommend transactions covered by the Recommendation Rule also must comply with these requirements as well as with the Rule’s requirement to review specific identified information.

The rule also exempts transactions with or for institutional investors. For purposes of this exemption, an account or customer must qualify either as an “institutional account” under NASD Rule 3110(c)(4) or as a “qualified purchaser” under Section 3(c)(7) of the Investment Company Act of 1940 (“ICA”).⁵ Transactions with or for institutional investors are exempt from the proposed rule since institutional customers are generally knowledgeable and sophisticated regarding investments in this marketplace.

In addition, the exemption would exclude from the scope of the proposed rule securities of certain issuers, including foreign issuers, with at least \$100 million in assets and \$10 million in shareholders’ equity, that are not listed on a national securities exchange or Nasdaq. The exemption is based on the premise that securities of these issuers are more likely to be

Exchange Act Release No. 29094 (April 17, 1991), 56 FR 19148 (April 25, 1991).

⁵ NASD Rule 3110(c)(4) defines an “institutional account” as the account of a bank, savings and loan association, insurance company, or registered investment company; an investment adviser registered under Section 203 of the Investment Advisers Act of 1940; or any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million. The term “qualified purchaser” as used in Section 3(c)(7) of the ICA is described in Section 2(a)(51) of the ICA as: (1) individuals who own \$5 million in investments and their spouses if they invest jointly; (2) specified family owned-companies with \$5 million in investments; (3) trusts established and funded by qualified purchasers for which investment decisions are made by a qualified purchaser; and (4) entities that in the aggregate own and invest on a discretionary basis for their own account, or for the accounts of other qualified purchasers, \$25 million in investments.

followed by market analysts, are less likely to be the subject of fraudulent sales practices, and are generally more liquid. This exemption also minimizes the potential that the proposed rule may competitively disadvantage well-capitalized, internationally-traded issuers that have chosen not to list on a national securities exchange or Nasdaq.

In setting the financial criteria for an exemption, the NASD selected financial criteria of at least \$100 million of total assets and stockholders' equity of at least \$10 million. This criteria comports with NASD Rule 4420(f) and Section 107(A) of the American Stock Exchange Guide, which sets forth the financial standards to qualify to quote on the Nasdaq and the Amex, respectively, for "other securities" that are not otherwise covered by conventional listing criteria for domestic and foreign issuers. In order to rely on the size exemption, a member must obtain the issuer's audited financial statements prepared in accordance with either U.S. or foreign Generally Accepted Accounting Principles and dated within 6 months of the date of the recommendation or trade to determine whether the issuer's securities qualify for the exemption.

Under the proposed rule, securities of banks, as defined under Section 3(a)(4) of the Exchange Act, and insurance companies are exempt from the proposed rules on the ground that banks and insurance companies are subject to independent oversight by federal and state regulatory authorities, and less likely to be the subject of market manipulation or issuer fraud.

Amendments to NASD Rule 6740

Currently, NASD Rule 6740 requires members to submit to the Association certain specified information as required by SEC Rule 15c2-11 before the member can initiate or resume quotations in a security in any inter-dealer quotation medium. The proposed amendment to NASD Rule 6740 will permit members to elect not to submit to the Association hard copies of issuer reports that are filed by the issuer through the SEC's EDGAR database and that currently

reside on such system. Under this alternative, members may submit to the NASD a certification that states that the member has conducted a review of the relevant documents and has fulfilled its SEC Rule 15c2-11 obligations, including the affirmative review obligation. This certification must be reviewed and signed by a principal of the member firm.

(b) 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 fraud in the trading of non-listed securities

4. 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.

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

The proposed rule change was published for comment in NASD Notice to Members 98-15 (Notice or NTM) in January, 1998. A total of 43 comments were received in response to the Notice. A copy of the NTM is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3. A summary of the comment letters received in response to the Notice is attached as Exhibit 4. As published in the Notice, the original proposed rule required members to review certain financial statements of an issuer prior to making a

recommendation in an OTC equity security to a customer (Rule 2315) and deliver to customers a disclosure statement regarding the differences between listed and OTC markets prior to the first purchase and annually thereafter (Rule 2360, which was proposed to be numbered Rule 2350 at the time the NTM was published).

Of the 43 responses received, most (25 responses, or approximately 60%) were from broker/dealer firms or registered persons and the balance (18 comments, or approximately 40%) were from individual investors, issuers, various state agencies, trade associations, and other interested parties. In providing comments, a majority of commenters expressed a position (i.e., approval or disapproval) regarding each specific proposal. Other commenters did not provide a stated position on each proposal, but identified particular issues with certain proposals and provided written comment.

As to proposed Rule 2315, 11 commenters approved or approved with qualification, and 18 commenters disapproved of, the rule proposal. The comments generally in favor of the proposal approved of the rule's placing responsibility on the firm that is soliciting an order and, indicated that, unless a broker/dealer is compelled to maintain information and review this information, fraudulent omission of material fact will occur. The comments opposing the proposal generally maintained that the current rules are sufficient and the proposed rules are extremely burdensome. In particular, the opponents state that the record keeping and compliance burden is particularly chilling to these stocks and the time it takes to locate and review financial statements on a company will limit a firm's stock selection.

We are not proposing to adopt Rule 2360 at this time. Therefore, this proposed rule change does not discuss the comments on that proposed rule.

After the public comment process, the staff recommended and the Boards approved the following modifications to the proposed rule at their meetings in May 1998. Proposed Rule 2315 was amended to add exemptions for securities of certain financially sizable issuers, securities of banks and insurance companies, and transactions with institutional investors. In addition, the Rule was amended to require a member to review certain current financial information and other business information about the issuer, in addition to the requirements set out in the original rule proposal, before making a recommendation to a customer, and to require members to designate a qualified registered individual to review the information required by the rule.

After NASD Board approval of the modifications to the proposed rules in May, the staff received an additional comment that requested the staff to consider an additional exemption from the scope of proposed Rule 2315. The commenter suggested that recommended sales transactions in OTC equity securities with customers should be exempt from proposed Rule 2315. The premise for the exemption is based on need to expedite liquidation of customer positions in OTC equity securities without the need for a member to review specified information regarding the issuer as required by the proposed rule. The commenter suggested that a delay in processing the sale may preclude a customer from capturing a particular market opportunity which may result in the customer reducing his return or increasing his loss in a particular investment. The suggested exemption would not apply to short sales by investors in these securities. Due to the nature and the timing of the comment, the staff is requesting that the Commission specifically request comment in its notice to the public on the potential need for such an exemption from proposed Rule 2315.

At a subsequent Board meeting in December 1998, the staff recommended and the Board approved further modifications to Rule 2315. In particular, the Board approved an expansion of

the definition of “current financial statements” in NTM 98-15 to include financial information contained in the registration statements of Securities Act registered securities and all financial information provided in connection with securities offered in connection with exemptions from registration provided by Regulation A, Rule 505, or Rule 506. The Board also approved a revision to the exclusions from the Rule for initial public offerings and offerings conducted in compliance with Regulation A and Rules 504-506 under the Securities Act. That exemption is now limited to transactions that meet the requirements of Rule 504 and Section 4(2) transactions.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Not applicable.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.
2. NASD Notice to Members 98-15, January, 1998.
3. Comments received in response to NASD Notices to Members 98-15.
4. Summary of comments received in response to NASD Notice to Members 98-15.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: _____
Joan C. Conley, Secretary

Date: January 13, 1999

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-99-4)

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

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on _____, 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 new National Association of Securities Dealers, Inc. ("NASD" or "Association") Rule 2315, which requires members to review current issuer information prior to recommending a transaction to a customer in an over-the-counter ("OTC") equity security. Additionally, the proposed rule change would amend NASD Rule 6740 to permit members to submit a certification to the Association that states that the member has conducted a review of specified information and has fulfilled its SEC Rule 15c2-11 obligations for documents that currently reside on the SEC's Electronic Data Gathering and Retrieval System (EDGAR) database. Below is the text of the proposed rule change. Proposed new language is underlined.

* * *

2315. Recommendations to Customers in OTC Equity Securities

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) (1) No member or person associated with a member shall recommend to a customer the purchase, sale, or exchange of 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 current financial statements of, and current business information about, the issuer, and makes a determination that such information, and any other information available, provides a reasonable basis under the circumstances for making the recommendation.

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

(A) a balance sheet as of a date less than 16 months before the date of the recommendation;

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

(C) 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;

(D) 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 regulatory authority, including the Commission, foreign regulatory authorities, bank and insurance regulators; and

(E) all 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.

(b) If an issuer has not made current filings required by any regulatory authority, including the Commission, a foreign regulatory authority, or bank and insurance regulators, such review must include 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.

(c) For purposes of this Rule, “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.

(d) A member firm shall designate a registered individual to conduct the review required by this rule. In making such designation, the member firm must ensure that

(1) either the individual is registered as a Series 24 principal, or his conduct in complying with the provisions of this Rule is appropriately supervised by a Series 24 individual; and

(2) such designated individual has the requisite skills, background and knowledge to conduct the review required under this rule.

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

(1) transactions that meet the requirements of Rule 504 of Regulation D under the Securities Act and transactions with an issuer not involving any public offering pursuant to Section 4(2) of the Securities Act;

(2) transactions with or for an account that qualifies as an “institutional account” under Rule 3110(c)(4) or with a customer that is a “qualified purchaser” under Section 3(c)(7) of the Investment Company Act;

(3) transactions in an issuer’s securities if the issuer has \$100 million in 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; or

(4) transactions in securities of a bank under Section 3(a)(4) of the Securities Exchange Act of 1934 and or insurance company subject to regulation by a state or federal bank or insurance regulatory authority.

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6740. Submission of Rule 15c2-11 Information on Non-Nasdaq Securities

(a) - (d) No change

(e) As an alternative to submitting to the Association a copy of the documents required by paragraph (b) of the Rule, a member may submit to the Association a certification signed by a principal of the member firm stating that the firm has complied with the requirements of SEC Rule 15c2-11, including the member's affirmative review obligation, as to any submission with respect to which the required documents currently reside in the SEC's EDGAR database.

* * *

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

(a) Purpose

The NASD has actively studied the OTC market in an effort to address the abuses in the trading and sales of thinly traded, thinly capitalized (microcap) securities. These securities are not listed on The Nasdaq Stock Market ("Nasdaq") or any exchange and trade on the OTC

Bulletin Board (“OTCBB”),¹ in the “pink sheets” published by the National Quotation Bureau, Inc. (“Pink Sheets”), and in other quotation media where there are no listing requirements. The NASD is concerned with actual and potential fraud or manipulation in the markets for these securities, and the connection between potential fraud and manipulation and the lack of reliable and current financial information about issuers of microcap securities.

In the listed securities markets, the quoted price of a security helps to reflect the information available about the listed security and its issuer. In the OTC market, which is less liquid and less transparent, there is a greater need for firms to independently review financial statements to verify that a recommended transaction in a microcap security is suitable. This proposal is meant to address this issue.

Proposed Rule 2315 – Recommendation Rule

Proposed Rule 2315 (“Recommendation Rule”) would prohibit a member or associated person from recommending a transaction to a customer in an OTC equity security that is published or quoted regularly in a quotation medium unless the member has first reviewed current financial statements and other business information about an issuer and determined that this information, along with other information available, provides a reasonable basis for making the recommendation. Application of the rule would be limited to equity securities that are not listed on Nasdaq or any exchange, and that are quoted on the OTCBB, in the Pink Sheets, or in

¹ The OTCBB is a quotation service that displays real-time quotes, last sale prices, and volume information in domestic and certain foreign securities. Eligible securities include national, regional, and foreign equity issues, warrants, units, and American Depositary Receipts (ADRs) not listed on any other U.S. national securities market or exchange. Unlike Nasdaq or registered national securities exchanges where individual companies apply for listing on the market---and must meet and maintain strict listing and maintenance standards---individual brokerage firms, or market makers, enter quotations for specific securities on their own behalf through the OTCBB.

any other system that regularly disseminates indications of interest and quotation information. Such systems would include Web sites, issuer trading services, and other non-member systems that provide this data to the public.

The requirements in the proposed rule would not affect requirements under the federal securities laws and under NASD rules requiring a broker/dealer that recommends securities to its customers to have a reasonable basis for those recommendations.² In addition, the proposed rule expressly 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 proposed rule requires members to obtain and review the issuer's "current financial statements" as defined in paragraph (a)(2) of the proposed rule. Specifically, members would be required to obtain and review an issuer's balance sheet that is dated within 16 months of the date of the recommendation, a profit and loss statement for the period of 12 months preceding the date of the balance sheet, and financial statements filed during the 12 months preceding the date of the recommendation.

Under circumstances in which a proposed recommendation to the customer is not made within six months of the date of the issuer's balance sheet, the member would be required to obtain and review an additional profit and loss statement of the issuer from the date of the

² See, e.g., SEC v. Hasho, 784 F. Supp. 1059 (S.D.N.Y. 1992), citing SEC v. Hanley, 415 F. 2d 589 (2nd Cir. 1969); Securities Exchange Act Release No. 29094 (April 17, 1991), 56 FR 19148 (April 25, 1991) (adopting amendments to Rule 15c2-11), n.22; and NASD Rule 2310 (Suitability Rule), which requires a member to have reasonable grounds for believing that a recommendation to a customer is suitable based on facts disclosed, other security holdings, and financial situation and needs.

balance sheet to a date within six months of the proposed recommendation to the customer.³ For example, if a member proposes to make a recommendation to a customer on March 15, 1999, the member would be required to obtain and review the following information to satisfy the proposed rule: a balance sheet of the issuer with a calendar year-end of December 31, 1997; a profit and loss statement for the 12-month period ended December 31, 1997; and a nine-month interim profit and loss statement for the period of January 1, 1998, through at least September 30, 1998.

When issuers file reports with the SEC or with other foreign or domestic regulatory authorities, the proposed rule would require members to collect and review all financial statements and other financial reports filed by the issuer within the twelve months preceding the recommendation. Members also must obtain and review financial information contained in registration statements of registered securities and all financial information provided in connection with securities offered pursuant to an exemption from registration.

If an issuer has not made current filings as required by a regulatory authority, a member must inquire into the circumstances concerning the issuer's failure to file current reports, and determine based on all the facts and circumstances whether a recommendation is appropriate under the circumstances. The evidence of the determination to make a recommendation in this situation should be in writing and maintained by the member.

The proposed rule requires a member to designate a registered individual to conduct a review of the information specified in paragraph (a)(2) of the proposed rule. In making this

³ This requirement is similar to language in paragraph (a)(5) of SEC Rule 15c2-11, which governs the initiation or resumption of quotations for non-reporting issuers. SEC Rule 15c2-11 requires a broker/dealer to collect and review certain information before initiating or resuming quotations in a quotation medium. See Securities Exchange Act Release No. 29094 (April 17, 1991), 56 FR 19148 (April 25, 1991).

determination, a member firm must ensure that either the individual is registered as a Series 24 principal, or his conduct in complying with the provisions of this proposed rule is appropriately supervised by a Series 24 individual. The designated individual should possess the requisite skills, background, and knowledge to conduct the review required by the proposed rule. The associated person making the recommendation to the customer is obligated, prior to the recommendation, to assure that the member has conducted such a review of the specified information in accord with the proposed rule. The member should document the list of information reviewed, the date of the review, and the name of the person performing the review of the required information under the proposed rule.

Exemptions

The proposed rule exempts from its coverage transactions that are exempt from registration under Section 4(2) of the Securities Act and transactions that meet the requirements of Rule 504 of Securities Act Regulation D. This exemption is based on the fact that, unlike the specific disclosure requirements that apply to registered and other offerings, the Securities Act does not mandate that Section 4(2) and Rule 504 issuers furnish specified information to purchasers. Hence, there is no specific information to review. The exemption also is based on the reduced manipulative potential associated with private offerings.

Because of this exemption, there are no specific review requirements under the proposed Recommendation Rule for broker/dealers that recommend transactions in securities exempt from registration under Rule 504 or Section 4(2) of the Securities Act. However, under prevailing law, including SEC Rule 10b-5 and NASD Rule 2310, a broker/dealer must have a reasonable basis for recommending a securities transaction to a customer and must make an appropriate suitability determination. In order to satisfy these requirements with respect to Rule 504 or

Section 4(2) exempt offerings, the broker/dealer must review any information provided by the issuer as well as other relevant information, including information obtained in response to “red flags” and otherwise. Broker/dealers that recommend transactions covered by the Recommendation Rule also must comply with these requirements as well as with the Rule’s requirement to review specific identified information.

The rule also exempts transactions with or for institutional investors. For purposes of this exemption, an account or customer must qualify either as an “institutional account” under NASD Rule 3110(c)(4) or as a “qualified purchaser” under Section 3(c)(7) of the Investment Company Act of 1940 (“ICA”).⁴ Transactions with or for institutional investors are exempt from the proposed rule since institutional customers are generally knowledgeable and sophisticated regarding investments in this marketplace.

In addition, the exemption would exclude from the scope of the proposed rule securities of certain issuers, including foreign issuers, with at least \$100 million in assets and \$10 million in shareholders’ equity, that are not listed on a national securities exchange or Nasdaq. The exemption is based on the premise that securities of these issuers are more likely to be followed by market analysts, are less likely to be the subject of fraudulent sales practices, and are generally more liquid. This exemption also minimizes the potential that the proposed rule may

⁴ NASD Rule 3110(c)(4) defines an “institutional account” as the account of a bank, savings and loan association, insurance company, or registered investment company; an investment adviser registered under Section 203 of the Investment Advisers Act of 1940; or any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million. The term “qualified purchaser” as used in Section 3(c)(7) of the ICA is described in Section 2(a)(51) of the ICA as: (1) individuals who own \$5 million in investments and their spouses if they invest jointly; (2) specified family owned-companies with \$5 million in investments; (3) trusts established and funded by qualified purchasers for which investment decisions are made by a qualified purchaser; and (4) entities that in the aggregate own and invest on a discretionary basis for their own account, or for the accounts of other qualified purchasers, \$25 million in investments.

competitively disadvantage well-capitalized, internationally-traded issuers that have chosen not to list on a national securities exchange or Nasdaq.

In setting the financial criteria for an exemption, the NASD selected financial criteria of at least \$100 million of total assets and stockholders' equity of at least \$10 million. This criteria comports with NASD Rule 4420(f) and Section 107(A) of the American Stock Exchange Guide, which sets forth the financial standards to qualify to quote on the Nasdaq and the Amex, respectively, for "other securities" that are not otherwise covered by conventional listing criteria for domestic and foreign issuers. In order to rely on the size exemption, a member must obtain the issuer's audited financial statements prepared in accordance with either U.S. or foreign Generally Accepted Accounting Principles and dated within 6 months of the date of the recommendation or trade to determine whether the issuer's securities qualify for the exemption.

Under the proposed rule, securities of banks, as defined under Section 3(a)(4) of the Exchange Act, and insurance companies are exempt from the proposed rules on the ground that banks and insurance companies are subject to independent oversight by federal and state regulatory authorities, and less likely to be the subject of market manipulation or issuer fraud.

Amendments to NASD Rule 6740

Currently, NASD Rule 6740 requires members to submit to the Association certain specified information as required by SEC Rule 15c2-11 before the member can initiate or resume quotations in a security in any inter-dealer quotation medium. The proposed amendment to NASD Rule 6740 will permit members to elect not to submit to the Association hard copies of issuer reports that are filed by the issuer through the SEC's EDGAR database and that currently reside on such system. Under this alternative, members may submit to the NASD a certification that states that the member has conducted a review of the relevant documents and has fulfilled its

SEC Rule 15c2-11 obligations, including the affirmative review obligation. This certification must be reviewed and signed by a principal of the member firm.

(b) 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 fraud in the trading of non-listed 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

The proposed rule change was published for comment in NASD Notice to Members 98-15 (Notice or NTM) in January, 1998. A total of 43 comments were received in response to the Notice. A copy of the NTM is attached as Exhibit 2. Copies of the comment letters received in response to the Notice are attached as Exhibit 3. A summary of the comment letters received in response to the Notice is attached as Exhibit 4. As published in the Notice, the original proposed rule required members to review certain financial statements of an issuer prior to making a recommendation in an OTC equity security to a customer (Rule 2315) and deliver to customers a disclosure statement regarding the differences between listed and OTC markets prior to the first

purchase and annually thereafter (Rule 2360, which was proposed to be numbered Rule 2350 at the time the NTM was published).

Of the 43 responses received, most (25 responses, or approximately 60%) were from broker/dealer firms or registered persons and the balance (18 comments, or approximately 40%) were from individual investors, issuers, various state agencies, trade associations, and other interested parties. In providing comments, a majority of commenters expressed a position (i.e., approval or disapproval) regarding each specific proposal. Other commenters did not provide a stated position on each proposal, but identified particular issues with certain proposals and provided written comment.

As to proposed Rule 2315, 11 commenters approved or approved with qualification, and 18 commenters disapproved of, the rule proposal. The comments generally in favor of the proposal approved of the rule's placing responsibility on the firm that is soliciting an order and, indicated that, unless a broker/dealer is compelled to maintain information and review this information, fraudulent omission of material fact will occur. The comments opposing the proposal generally maintained that the current rules are sufficient and the proposed rules are extremely burdensome. In particular, the opponents state that the record keeping and compliance burden is particularly chilling to these stocks and the time it takes to locate and review financial statements on a company will limit a firm's stock selection.

We are not proposing to adopt Rule 2360 at this time. Therefore, this proposed rule change does not discuss the comments on that proposed rule.

After the public comment process, the staff recommended and the Boards approved the following modifications to the proposed rule at their meetings in May 1998. Proposed Rule 2315 was amended to add exemptions for securities of certain financially sizable issuers, securities of

banks and insurance companies, and transactions with institutional investors. In addition, the Rule was amended to require a member to review certain current financial information and other business information about the issuer, in addition to the requirements set out in the original rule proposal, before making a recommendation to a customer, and to require members to designate a qualified registered individual to review the information required by the rule.

After NASD Board approval of the modifications to the proposed rules in May, the staff received an additional comment that requested the staff to consider an additional exemption from the scope of proposed Rule 2315. The commenter suggested that recommended sales transactions in OTC equity securities with customers should be exempt from proposed Rule 2315. The premise for the exemption is based on need to expedite liquidation of customer positions in OTC equity securities without the need for a member to review specified information regarding the issuer as required by the proposed rule. The commenter suggested that a delay in processing the sale may preclude a customer from capturing a particular market opportunity which may result in the customer reducing his return or increasing his loss in a particular investment. The suggested exemption would not apply to short sales by investors in these securities. Due to the nature and the timing of the comment, the staff is requesting that the Commission specifically request comment in its notice to the public on the potential need for such an exemption from proposed Rule 2315.

At a subsequent Board meeting in December 1998, the staff recommended and the Board approved further modifications to Rule 2315. In particular, the Board approved an expansion of the definition of “current financial statements” in NTM 98-15 to include financial information contained in the registration statements of Securities Act registered securities and all financial information provided in connection with securities offered in connection with exemptions from

registration provided by Regulation A, Rule 505, or Rule 506. The Board also approved a revision to the exclusions from the Rule for initial public offerings and offerings conducted in compliance with Regulation A and Rules 504-506 under the Securities Act. That exemption is now limited to transactions that meet the requirements of Rule 504 and Section 4(2) transactions.

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