

# SPECIAL NASD NOTICE TO MEMBERS 98-15

NASD Regulation Requests  
Comment On Proposal To  
Adopt Recommendation  
And Disclosure Rules For  
Over-The-Counter (OTC)  
Equity Securities;  
**Comment Period Expires  
February 16, 1998**

## Suggested Routing

- ☒ Senior Management
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## Executive Summary

NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) requests comment on two proposed rules, National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) Rules 2315 and 2350, which would require members to review current issuer financial statements prior to recommending a transaction to a customer in an over-the-counter (OTC) equity security, and to deliver a disclosure statement to a customer prior to an initial purchase of an OTC equity security, respectively.

Questions concerning this *Notice* may be directed to David Spotts, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8071.

## Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, N.W.  
Washington, D.C. 20006-1500;

or e-mailed to:  
[pubcom@nasd.com](mailto:pubcom@nasd.com)

Comments must be received **by February 16, 1998**. Before becoming effective, any rule change developed as a result of the comments received must be adopted by the NASD Regulation, Inc., Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

# NASD REGULATION REQUEST FOR COMMENT 98-15

## Executive Summary

NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) requests comment on two proposed rules, National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) Rules 2315 and 2350, which would require members to review current issuer financial statements prior to recommending a transaction to a customer in an over-the-counter (OTC) equity security, and to deliver a disclosure statement to a customer prior to an initial purchase of an OTC equity security, respectively.

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## Background

On December 11, 1997, the NASD Board of Governors (NASD Board) approved the solicitation of comment on four rule proposals regarding the OTC market and the OTC Bulletin Board<sup>®</sup> (OTCBB). This *Notice* will specifically address in detail two of the four rule proposals. First, proposed Rule 2315 requires a member and associated person to review reasonably current financial statements of an issuer prior to recommending a transaction to a customer in an OTC equity security (Recommendation Rule). Second, proposed Rule 2350 requires a member to deliver a disclosure statement to customers prior to an initial purchase of an OTC equity security and annually (Disclosure Rule). The text of proposed Rules 2315 and 2350 follows this *Notice*.

The two other rule proposals the NASD Board approved for solicitation of comment include: a proposed rule prohibiting a member from quoting a security on the OTCBB unless the issuer has made current filings with the Securities and Exchange

Commission (SEC) or other regulatory authority, and a proposed rule limiting quotations on the OTCBB to the securities of issuers that are current in their reports filed with the SEC or other regulator. These two rule proposals will amend existing NASD Rules 6530 and 6540. The accompanying *Notice to Members 98-14* separately discusses these proposed rule amendments.

Staff of NASD Regulation and The Nasdaq Stock Market<sup>SM</sup> (Nasdaq<sup>®</sup>) have 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 or any exchange and trade on the OTCBB, in the “pink sheets” published by the National Quotation Bureau, Inc. (Pink Sheets), and in other quotation media where there are no listing requirements. NASD Regulation and Nasdaq are 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. The regulatory proposals concerning the microcap market by NASD Regulation and Nasdaq are meant to address these issues and the public perception that the OTCBB is equivalent to The Nasdaq Stock Market or exchange markets in terms of standards, regulatory structure and oversight.

These proposals were developed in an effort to balance the benefits that transparency provides with the need for public information about the issuers. While the OTCBB provides real-time quotations for these securities, and other quotation media for OTC securities do not, transactions in OTC securities are nonetheless subject to real-time last sale trade

reporting. These trade reports are publicly disseminated through market data vendors on a real-time basis.

In light of the above, the staff recommended, and the NASD Board approved, the solicitation of comment on four rule proposals that would address certain identifiable issues in the OTC market. These proposed rules would: (1) limit quotations on the OTCBB to the securities of issuers that make current filings pursuant to the Securities Exchange Act of 1934 (Exchange Act), registered closed-end investment companies, and insurance companies and banks that provide current financial reports to their regulatory authorities; (2) prohibit member firms from quoting an issuer's security if the issuer has not made current filings with the SEC or the appropriate insurance or bank regulatory authority, and for those issuers that do not file through EDGAR,<sup>1</sup> require a member to provide such reports to the NASD; (3) require members and associated persons to review current financial statements prior to making a recommendation to a customer in an OTC equity security (Recommendation Rule); and (4) require members to provide each customer with a disclosure statement prior to effecting an initial purchase in an OTC equity security and annually (Disclosure Rule).

### **Proposed Recommendation Rule**

This proposed 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 or associated person has first reviewed reasonably current financial statements of the issuer, and determined that these financial statements, along with other information available, provide a reasonable basis for making the recommendation.

The proposed 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 be in addition to other requirements under the federal securities laws and under NASD rules that a broker/dealer that recommends securities to its customers is required to have a reasonable basis for those recommendations.<sup>2</sup>

The proposed rule is specifically designed to cover transactions in the over-the-counter market. Paragraph (e) of the proposed rule sets forth exemptions involving issuer transactions. The proposed rule exempts from its coverage transactions in registered initial public offerings, Regulation A offerings under the Securities Act of 1933 (Securities Act), transactions that are exempt from registration under Section 4(2) of the Securities Act, and transactions that meet the requirements of Rules 504, 505 and 506 of Securities Act Regulation D. These exemptions are based on the specific disclosure requirements that apply to registered and other offerings, and on the reduced manipulative potential associated with initial offers in private offerings. The existence of these exemptions is not, however, intended to provide an exception from the independent obligation to review such financial information as may be necessary to support a recommendation in a particular case. Transactions with institutional investors are, however, subject to the requirements of the proposed rule.

The proposed rule requires a member or associated person to obtain and

review reasonably current financial statements of the issuer before making a recommendation to a customer. Paragraph (c) of the proposed rule sets forth time frames in which an issuer's financial statements will satisfy the "reasonably current" requirement of paragraph (a). This language 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.<sup>3</sup> To satisfy paragraph (c), a member or associated person would be required to obtain and review a balance sheet of the issuer that is dated within 16 months of the date of the recommendation, and an associated profit and loss statement of the issuer for the period of 12 months preceding the date of the balance sheet.

If the date of the proposed recommendation to the customer is not within six months of the date of the balance sheet, the member or associated person 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 (interim statement). For example, if a member is proposing to make a recommendation to a customer on March 15, 1998, the member would be required to obtain and review the following information to satisfy paragraph (c) of the proposed rule: a balance sheet of the issuer with a calendar year-end of December 31, 1996; a profit and loss statement for the 12-month period ended December 31, 1996; and a nine-month interim profit and loss statement for the period of January 1, 1997, through September 30, 1997.

As a result of these requirements, members or associated persons may not recommend those OTC equity securities of issuers that fail to prepare or provide interim profit and

loss statements to members or associated persons longer than six months after the balance sheet dates unless an exemption applies. NASD Regulation is specifically requesting comment on whether requiring the preparation of interim profit and loss statements would be unduly burdensome for issuers or members in connection with these specific issuers that may typically prepare only year-end financial statements (*e.g.*, certain foreign private issuers, insurance companies).

NASD Regulation is also soliciting comment on whether an additional exemption should be adopted that would exempt certain equity securities from the proposed rule if the issuer meets certain financial size requirements (*e.g.*, Nasdaq SmallCap initial financial listing requirements). This would exempt from the proposed rule equity securities of certain issuers with significant financial conditions and operations.

Because the proposed rule will place an increased burden on retail firms, NASD Regulation is specifically soliciting comment on whether both the member firm and its registered representative must perform the review required by the proposed rule, or whether it would be sufficient if either the firm or the representative making the recommendation conducted the review.

NASD Regulation is specifically soliciting comment on whether a record keeping requirement should be imposed on the member broker/dealer under this proposed rule or, if such a requirement is not imposed, how compliance with the proposed rule could be monitored. The record keeping requirement could obligate a member to maintain a record of the actual date and the name of the person performing the review of the required financial statements and other information under the proposed rule.

### Proposed Disclosure Rule

This proposed rule would require the member to provide a "Disclosure Statement" to an investor, and obtain a signed acknowledgment of receipt, prior to the initial purchase of an OTC equity security, and annually thereafter. The requirement to deliver a Disclosure Statement annually, however, would be suspended with respect to any year during which the customer effects no purchases in OTC equity securities. The Disclosure Statement would be a standard form, prepared by the NASD. It would inform the investor of the differences between the OTC market and Nasdaq and listed exchange markets, including the differences in market characteristics, the liquidity of the securities, and the obligations of market makers.<sup>4</sup>

The proposed rule would apply to all transactions (solicited or unsolicited) in OTC equity securities, including an initial registered public offering not listed on an exchange or on Nasdaq.<sup>5</sup> The OTC equity securities in these offerings are included in the proposed rule, since these securities could potentially be quoted by broker/dealers in the OTC market, and investors should receive certain disclosures regarding the characteristics of the potential trading market and the corresponding regulatory structure and oversight of the market. In addition, the proposed rule would not apply to exempt transactions under Section 4(2) of the Securities Act and transactions meeting the requirements of Rules 505 and 506 of Securities Act Regulation D. These transactions are excluded from the scope of the proposed rule since they are deemed either transactions not involving a public offering or transactions generally involving certain qualified or sophisticated investors (*i.e.*, accredited investors).

Further, transactions with certain institutional customers and institutional

accounts that meet the requirements of Section 3(c)(7) of the Investment Company Act of 1940 and NASD Rule 3110(c)(4), respectively, are exempt from the requirements of the proposed rule. This particular class of customer or account is excluded from the proposed rule since it is assumed that these customers and accounts maintain a certain level of sophistication in financial markets and products and would not have a particular need for the Disclosure Statement. Transactions relying on the exemption provided in Rule 504 of Securities Act Regulation D would, however, be subject to the proposed rule because, for regulatory purposes, these offerings are treated as public offerings provided that they are made within the quantitative requirements of Rule 504.

NASD Regulation is soliciting comment on whether any alternative approaches exist to the requirement that the firm obtain from the customer a written acknowledgment of receipt of the Disclosure Statement prior to effecting an initial purchase of an OTC equity security and annually. For example, should members accept customer acknowledgments electronically? Another alternative is to permit members to mail the Disclosure Statement to the customer with the confirmation statement. Comment is requested on all approaches that would achieve the regulatory goal.

NASD Regulation is also specifically soliciting comment on the impact that this rule proposal will have on customer trades effected through automated computer systems, and soliciting comment on the specific content of the Disclosure Statement to customers. *See* endnote number 4 of this *Notice* for a summary of the proposed contents of the Disclosure Statement.



NASD Regulation is also aware that members may have an additional obligation under Exchange Act Rule 15g-2 to deliver a disclosure statement to customers prior to a recommended transaction in penny stocks, as defined in Exchange Act Rule 3a51-1. As contrasted to the requirements in Rule 15g-2, the proposed rule applies to all transactions in OTC equity securities with customers and is not limited to penny stocks or to recommended transactions. During the comment process, NASD Regulation will particularly consider the need and ability to integrate these two requirements so they can be satisfied by one disclosure document.

### Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, N.W.  
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Comments must be received by **February 16, 1998**. Before becoming effective, any rule change developed as a result of the comments received must be adopted by the NASD Regulation, Inc., Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

### Text of Proposed Rule 2315

(Note: All language is new.)

#### Rule 2315. Recommendation to Customers in OTC Equity Securities

(a) 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 or person associated with a member has reviewed reasonably current financial statements of the issuer, and such financial statements and other information available provides a reasonable basis under the circumstances for making the recommendation.

(b) For purposes of this Rule, an issuer's "financial statements" include a balance sheet and a statement of profit and loss (or an income statement), and, if available, a statement of changes in stockholders' equity and a statement of cash flows.

(c) The requirement in paragraph (a) of this Rule that financial statements be "reasonably current" will be satisfied, unless the member has more current financial statement information in its possession, if:

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

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

(3) if the balance sheet is not as of a date less than 6 months before the date of the recommendation, it shall be accompanied by 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) 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.

(e) The requirements of this Rule shall not apply to transactions in a registered initial public offering, transactions in a Regulation A offering, transactions that meet the requirements of Rules 504, 505, and 506 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.

### Text of Proposed Rule 2350

(Note: All language is new.)

#### Rule 2350. Disclosure Document to Customers

(a) It shall be unlawful for a member to effect a purchase for a customer in any equity security, other than a transaction described in paragraph (b), unless, prior to effecting the first purchase, and on an annual basis thereafter, the member has furnished to the customer a document containing the information set forth in Schedule \_\_\_ below and has obtained from the customer a manually signed and dated written acknowledgment of receipt of the Schedule.

(b) This Rule shall not apply to transactions:

(1) in securities listed on Nasdaq or on a national securities exchange;

securities issued by registered investment companies; and options issued by the Options Clearing Corporation.

(2) with an issuer involving a public offering of securities that are listed or conditionally approved for listing on Nasdaq or a national securities exchange, or not involving a public offering under Section 4(2) of the Securities Act of 1933 (“Securities Act”), or meeting the requirements of Rule 505 or Rule 506 of Regulation D under the Securities Act; or

(3) 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 of 1940.

(c) A member will not be required to deliver the annual disclosure document referred to in paragraph (a) of this Rule to any customer who has not effected through it a purchase in any equity security, other than those set forth in paragraph (b), for 12 months from the date of receipt of the previous disclosure Schedule.

(d) The member shall preserve, as part of its records, a copy of the written acknowledgment required by paragraph (a) of this Rule for the period specified in Securities Exchange Act Rule 17a-4(b).

### Endnotes

<sup>1</sup> EDGAR (Electronic Data Gathering, Analysis, and Retrieval) is the SEC system for the receipt, acceptance, review and dissemination of documents submitted in electronic format.

<sup>2</sup> 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).

<sup>3</sup> SEC Rule 15c2-11 requires a broker/dealer to collect and review certain issuer information before initiating or resuming quotations in a quotation medium. See SEC Rel. No. 34-29094 (April 17, 1991), 56 FR 19148 (April 25, 1991).

<sup>4</sup> The Disclosure Statement would be prepared by the NASD in order to standardize

the contents. It would contain, at a minimum, the following information: (1) a clear statement that: OTC equity securities are not listed on The Nasdaq Stock Market or on a national securities exchange; the OTCBB is a quotation medium, not an issuer listing service; and the OTCBB should not be confused with The Nasdaq Stock Market; (2) a description of the special characteristics and risks of the OTC equities markets and the operation of the OTCBB and the Pink Sheets, highlighting the fact that there are not quantitative or qualitative standards for issuers to be quoted in this market; (3) a statement emphasizing that, because a significant number of OTC equities do not file financial reports with the SEC, an investor may be unable to gain access to any financial or operational information regarding the issuer; and (4) a comparison of the OTC equities market with The Nasdaq Stock Market and other listed markets, including differences in liquidity and market maker obligations.

<sup>5</sup> Delivery of the Disclosure Statement would not be required if the issuer has received conditional approval for listing.

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