

that there is good cause and it is in the public interest to extend the comment period for an additional 90 days beyond the 90 days already provided. This will allow time for a virtual public meeting and allow the public more time to thoroughly review the issues and draft helpful comments. We believe this will help us prepare a final rule that will promote safety and minimize hardship on those the rule would affect. Accordingly, the comment period for Notice No. 03-10 is extended until April 19, 2004.

Issued in Washington, DC, on January 14, 2004.

**Steven W. Douglas,**

*Acting Director, Flight Standards Service.*

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## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release No. 34-49037; File No. S7-02-04]

RIN 3235-A102

### Amendments to the Penny Stock Rules

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed rule.

**SUMMARY:** The Securities and Exchange Commission is proposing to amend the definition of “penny stock” as well as the requirements for providing certain information to penny stock customers. The proposed amendments are designed to address market changes, evolving communications technology and recent legislative developments.

**DATES:** Comments must be submitted on or before March 16, 2004.

**ADDRESSES:** To help us process and review your comments more efficiently, comments should be sent by hard copy or electronic mail, but not by both methods. If comments are submitted in paper format, four copies should be addressed to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609. Comments in electronic format should be submitted to the following E-mail address: [rule-comments@sec.gov](mailto:rule-comments@sec.gov). All comment letters should refer to File No. S7-02-04; this file number should be included on the subject line if E-mail is used. All comments received will be posted on the Commission's Internet Web site (<http://www.sec.gov>) and made available for public inspection and copying in the Commission's Public

Reference Room, 450 Fifth Street, NW., Washington, DC 20549.<sup>1</sup>

#### FOR FURTHER INFORMATION CONTACT:

Catherine McGuire, Chief Counsel, Paula R. Jensen, Deputy Chief Counsel, Brian A. Bussey, Assistant Chief Counsel, or Norman M. Reed, Special Counsel, at 202/942-0073, Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-1001.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission (“Commission”) is requesting public comment on proposed amendments to Rule 3a51-1 [17 CFR 240.3a51-1], Rule 15g-2 [17 CFR 240.15g-2], Rule 15g-9 [17 CFR 240.15g-9], and Rule 15g-100 [17 CFR 240.15g-100] under the Securities Exchange Act of 1934 (“Exchange Act”).

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#### I. Executive Summary

In light of changing market structures, new technology and legislative changes, we are proposing amendments to the definition of “penny stock,” as well as amendments to rules requiring broker-dealers to provide certain information to customers regarding penny stock transactions.

Under the proposed amendments, the current exclusions from the definition of penny stock for reported securities and for certain other exchange-registered securities would be amended to require that these securities also satisfy one of the following new standards. First, an exchange-registered security could qualify if the exchange on which it is registered has been continuously registered since the Commission initially adopted the penny stock rules (as defined below) and if the exchange

has maintained and continues to maintain quantitative listing standards substantially similar to those in place on January 8, 2004. Second, an exchange-registered security or a reported security listed on an automated quotation system sponsored by a registered national securities association (including The Nasdaq Stock Market, Inc. (“Nasdaq”)) could qualify if the exchange or automated quotation system on which it is registered or listed has quantitative listing standards that meet or exceed standards modeled on those currently required for inclusion in the Nasdaq SmallCap Market. In addition, the proposed amendments would exclude security futures products from the definition of penny stock, and eliminate an outdated exclusion for securities quoted on Nasdaq. We do not intend these proposals, if adopted, to disturb the status quo with respect to securities relying on the current exclusions from the definition of penny stock as of January 8, 2004.

The proposed amendments would also provide an explicit “cooling-off period” to replace the implicit period that customers traditionally have had when the disclosure required by the penny stock rules is provided by postal mail rather than electronically. Moreover, the proposed amendments would revise the penny stock disclosure document (as defined below) and the instructions to it set forth in Schedule 15G under the Exchange Act.<sup>2</sup> The revisions would update the disclosure document, as well as streamline it to make it more readable.

Taken as a whole, these proposed amendments are intended to ensure that investors continue to receive the protections of the penny stock rules, regardless of changing technology or market structures.

#### II. Introduction

As Congress explicitly directed through the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (“Penny Stock Reform Act”),<sup>3</sup> the Commission adopted a series of rules requiring broker-dealers to provide customers with certain trade and market information prior to effecting a transaction in a penny stock for their customers.<sup>4</sup> Rules 15g-1 through 15g-9 under the Exchange Act (collectively known as the “penny stock rules”)

<sup>2</sup> 17 CFR 240.15g-100.

<sup>3</sup> Pub. L. 101-429, 104 Stat. 931 (1990); see Exchange Act Rel. No. 30608 (Apr. 20, 1992), 57 FR 18004 (Apr. 28, 1992) (“Adopting Release”).

<sup>4</sup> Among other things, the Penny Stock Reform Act added Section 15(g) to the Exchange Act. See Pub. L. 101-429, at Sec. 502; see also Adopting Release, 57 FR at 18006.

<sup>1</sup> We do not edit personal, identifying information such as names or e-mail addresses from electronic submissions. Submit only information you wish to make public.

implement the Congressional directive to increase the level of disclosure to investors concerning penny stocks generally as well as the specific penny stock involved in a transaction.<sup>5</sup> The scope of the penny stock rules is delineated by the definition of penny stock in Exchange Act Section 3(a)(51)<sup>6</sup> and Rule 3a51-1<sup>7</sup> thereunder.

The Commission believes that the penny stock rules have largely succeeded in providing first-time buyers of penny stocks with useful information as well as time to fully consider and reflect on their decision to purchase these often risky investments. We are, however, concerned that evolving technology, market changes and legislative developments could undermine these salutary rules and possibly subject penny stock investors to the abuses of the past. In light of these changes, the Commission proposes to update the definition of penny stock in Rule 3a51-1 as well as the procedural requirements of Rules 15g-2 and 15g-9 so that the penny stock rules can better accommodate both recent and future changes, including the growth of new markets and new market structures. We also propose to update and make conforming amendments to Schedule 15G, entitled "Information to be included in the document distributed pursuant to 17 CFR 240.15g-2."<sup>8</sup>

In proposing these rule amendments, we do not intend to create impediments to small companies' access to the capital markets or eliminate a viable secondary market for their securities. The Commission recognizes the important contributions that small companies make to the economy. We are mindful, however, that fraudulent sales practices, which have occurred and still occur in this area of the market, may not only harm investors financially but also undermine investor confidence.<sup>9</sup> Indeed, the diversion of substantial capital to unscrupulous promoters and broker-dealers does more than cause the loss of the productive use of investor funds. It may also discourage further investment by those who have been defrauded. Moreover, issuers of penny stocks that are fraudulently traded may

themselves be victimized by this activity.<sup>10</sup>

### III. Proposed Amendments to Rule 3a51-1

We believe that the definition of the term "penny stock," which we adopted in 1992, should be updated to take into account both market and legal developments. Among other things, the proposed amendments to Rule 3a51-1 would address an unintended consequence of national securities exchanges developing new markets or "junior" tiers of listed securities similar to, for example, Nasdaq's Over-the-Counter Bulletin Board service ("OTC Bulletin Board") or the American Stock Exchange LLC's now defunct Emerging Company Marketplace, that would not meet the more stringent listing standards of the primary exchange.<sup>11</sup>

<sup>10</sup> This characterization of the penny stock market reform initiative was embraced broadly in the Congress. For example, Congressman Wyden stated:

Some said, for example, that this bill could retard the capital formation process, that somehow, by having some minimum basic standards to protect the small investor, this would retard capital formation. I just feel very strongly that that argument is off base. If anything, I think what has happened over the years, has been that capital which small investors have, scarce capital, has been diverted to these penny stock frauds. And if, with additional scrutiny and oversight, we can prevent penny stock fraud, I think that will free up more capital to be invested at this critical time, especially in the small business sector of our economy.

136 Cong. Rec. H 8534, Vol. 136 No. 125 (Oct. 1, 1990) (remarks by Mr. Wyden on Securities Enforcement Remedies and Penny Stock Reform Act of 1990).

In addition, Congressman Rinaldo stated:

This bill ranks with the most important legislation we will consider this year. It will bring the longstanding national disgrace of an inadequately regulated penny stock market to a close. It mandates and authorizes the Securities and Exchange Commission to provide greater protection to investors in low priced securities. In developing this legislation my colleagues and I worked hard to identify the problems of the penny stock market, and we have proposed solutions that will increase investor protection and not interfere with the ability of small businesses to raise capital.

136 Cong. Rec. H 8534, Vol. 136 No. 125 (Oct. 1, 1990) (remarks by Mr. Rinaldo on Securities Enforcement Remedies and Penny Stock Reform Act of 1990).

<sup>11</sup> The Emerging Company Marketplace consisted of a "junior" tier of listed securities that did not meet the listing standards of the American Stock Exchange LLC, but was otherwise subject to many of its regulatory requirements (e.g., last sale reporting, trading and specialist allocation rules, certain corporate governance requirements, and surveillance procedures). It was intended to provide small companies that would not otherwise qualify for an exchange listing with an opportunity to list their securities. See Exchange Act Rel. No. 30445 (Mar. 5, 1992), 57 FR 8693 (Mar. 11, 1992).

On June 9, 1995, the American Stock Exchange LLC submitted to us, pursuant to Section 19(b)(1) of the Exchange Act and Rule 19b-4, a proposed rule change to discontinue the listing of new companies on the Emerging Company Marketplace. See Exchange Act Rel. No. 36079 (Aug. 9, 1995), 60 FR 42926 (Aug. 17, 1995) (approving the proposed rule change).

Such new markets would be facilities of national securities exchanges. Thus, unless the definition of penny stock is modified to account for such developments, the securities trading on such facilities would be excluded from the definition of penny stock even though these securities would have the essential attributes of penny stocks and would, therefore, be exactly the sort of risky investments to which Congress intended the additional investor protections of the penny stock rules to apply.

In considering how to adapt the penny stock rules to evolving market structures, however, we have also reassessed the definition of penny stock more broadly and are of the view that this definition has not kept pace with market developments. The past decade has seen a series of dynamic market changes, and we expect the process to continue. We have, therefore, developed a definition of the term penny stock that is designed to keep pace with this process. As markets evolve and exchanges and registered national securities associations continue to develop using different models, we believe this proposed framework will work better than a market-by-market analysis.

### A. Proposed Amendments Regarding Reported Securities and Other Exchange-Registered Securities

Congress explicitly gave the Commission the authority to prescribe the criteria national securities exchanges and automated quotation systems of registered national securities associations must meet in order to qualify their securities for an exclusion from the definition of penny stock.<sup>12</sup> Our original penny stock rules reflected Congress's view that many of the abuses occurring in the penny stock market were caused by the lack of publicly available information about the market in general and about the price and trading volume of particular penny stocks.<sup>13</sup> Many of the historically

<sup>12</sup> Sections 3(a)(51)(A)(i) and (ii) of the Exchange Act [15 U.S.C. 78c(51)(A)(i) and (51)(A)(ii)] provide that the term "penny stock" means any equity security other than a security that is "registered or approved for registration and traded on a national securities exchange that meets such criteria as the Commission shall prescribe by rule or regulation for purposes of this paragraph" or that is "authorized for quotation on an automated quotation system sponsored by a registered securities association, if such a system (I) was established and in operation before January 1, 1990, and (II) meets such criteria as the Commission shall prescribe by rule or regulation for purposes of this paragraph."

<sup>13</sup> See House Comm. on Energy and Commerce, Report to Accompany the Penny Stock Reform Act of 1990, H.R. Rep. No. 617, 101st Cong., 2d Sess. 20 (July 23, 1990) (reporting H.R. 4497) ("House

<sup>5</sup> 15 U.S.C. 78o(g).

<sup>6</sup> 15 U.S.C. 78c(a)(51).

<sup>7</sup> 17 CFR 240.3a51-1.

<sup>8</sup> 17 CFR 240.15g-100.

<sup>9</sup> See *SEC v. Hasho*, 784 F. Supp. 1059; 1063 (S.D.N.Y. 1992) ("Defendants' contemptible conduct did more than harm their clients; their actions destroy investor confidence, pollute the environment for securities transactions, and bring disgrace and shame upon Wall Street.").

abusive practices in the penny stock market arose from broker-dealers communicating to their customers false or misleading information as to the value or market price of securities in order to induce transactions in those securities.<sup>14</sup> These practices were more likely to flourish where there was a paucity of price, quotation and other market information.<sup>15</sup> We encouraged increased transparency in the market because we believed that this information would enable investors to better judge the veracity of the claims of sales agents.<sup>16</sup>

The exclusions from the definition of penny stock for any security that is a reported security<sup>17</sup> and for certain other securities that are registered, or approved for registration upon notice of issuance, on a national securities exchange<sup>18</sup> are largely based on the transparency and oversight fostered by

Report”) (“Because it is wrapped in secrecy and operates in relative obscurity, the penny stock market lends itself to manipulation far more easily than a market where information is readily available and circulated to investors.”).

<sup>14</sup> Exchange Act Rel. No. 29093 (Apr. 17, 1991), 56 FR 19165, 19169 (Apr. 25, 1991) (“Proposing Release”), proposing certain of the penny stock rules.

<sup>15</sup> *Id.*

<sup>16</sup> See also Exchange Act Rel. No. 27160 (Aug. 22, 1989), 54 FR 35468, 35470 (Aug. 28, 1989). (“[M]any low-priced securities are issued by smaller, little known companies that may attract little attention outside that generated by a boiler room sales campaign. \* \* \*. The scarcity of information about the issuer is further aggravated by the lack of information on transactions in the issuers’ securities.”).

<sup>17</sup> Under current Rule 3a51-1(a), equity securities that are reported securities as defined in 17 CFR 240.11Aa3-1(a) are not penny stocks. 17 CFR 240.11Aa3-1(a)(4) defines “reported security” as any exchange-listed equity security or Nasdaq security for which transaction reports are made available on a real-time basis pursuant to an effective transaction reporting plan. An “effective transaction reporting plan” refers to a transaction reporting plan that the Commission has approved pursuant to Rule 11Aa3-1. 17 CFR 240.11Aa3-1(a)(3). See also Adopting Release, 57 FR at 18008 (“As adopted, Rule 3a51-1 excludes from the definition of penny stock any equity security that is a reported security—that is, any exchange-listed or NASDAQ security for which transaction reports are required to be made on a real-time basis pursuant to an effective transaction reporting plan.”).

<sup>18</sup> Current Rule 3a51-1(e) provides an exclusion for any security “that is registered, or approved for registration upon notice of issuance, on a national securities exchange that makes transaction reports available pursuant to 17 CFR 240.11Aa3-1 of this chapter, provided that: current price and volume information with respect to transactions in that security is required to be reported on a current and continuing basis and is made available to vendors of market information pursuant to the rules of the national securities exchange; and the security is purchased or sold in a transaction that is effected on or through the facilities of the national securities exchange, or that is part of a distribution of the security.” 17 CFR 3a51-1(e).

listing on such markets.<sup>19</sup> As we noted when we proposed the penny stock rules, “securities that are traded in a market that is subject to a comprehensive regulatory scheme requiring real-time transaction reporting and the extensive surveillance systems that this reporting supports, are less likely to be purchased or sold by means of manipulative sales tactics.”<sup>20</sup>

During the decade since we adopted the penny stock rules, several developments have enhanced transparency with regard to trading in low-priced securities. For example, securities trading on the OTC Bulletin Board are now subject to last sale transaction reporting within 90 seconds after execution.<sup>21</sup> In addition, quotation on the OTC Bulletin Board is now limited to the securities of companies that report their current financial information to the SEC, banking or insurance regulators and that are current in those reports.<sup>22</sup> Moreover, Nasdaq now has the ability, in certain limited circumstances, to halt trading or quoting in an OTC Bulletin Board security when necessary to protect investors and the public interest.<sup>23</sup>

<sup>19</sup> Adopting Release, 57 FR at 18008 (“In the Proposing Release, the Commission concluded that reported securities should be excluded from the penny stock rules because they are subject to the rules of self-regulatory organizations (“SROs”) that set specific standards for inclusion, promote efficient pricing and transaction execution procedures, and generate public price information for evaluation by professional securities analysts and the financial press.”).

See also *id.* at 18010 (“For similar [transparency] reasons, Rule 3a51-1 as adopted provides an exclusion in paragraph (e) for any security that is registered, or approved for registration upon notice of issuance, on a national securities exchange, provided that current price and volume information with respect to transactions in that security is required to be reported and is made available to vendors pursuant to the rules of the national securities exchange. Securities that are listed on the regional exchanges also are subject to general reporting requirements under the rules of those exchanges. Investors therefore have a greater ability to evaluate and to monitor the market price of listed securities without having to rely exclusively on the representations of their broker-dealers. In addition, issuers of these securities are required to meet minimum qualification and maintenance standards for listing on the exchange. The Commission believes that these requirements, together with comprehensive exchange surveillance, also make the protection provided by the penny stock rules less necessary for securities listed and traded on the regional exchanges.”).

<sup>20</sup> Proposing Release, 56 FR at 19172.

<sup>21</sup> See NASD Rule 6550 (adopted in 1993); see also Exchange Act Rel. No. 32647 (July 16, 1993), 58 FR 39262 (July 22, 1993).

<sup>22</sup> See NASD Rule 6530; Exchange Act Rel. No. 40878 (Jan. 4, 1999), 64 FR 1255 (Jan. 8, 1999); see also NASD Notice to Members 99-15.

<sup>23</sup> See NASD Rule 6545 (adopted in 2000); see also Exchange Act Rel. No. 42806 (May 22, 2000), 65 FR 34518 (May 30, 2000).

Efforts to increase transparency can also be seen in the “pink sheets,”<sup>24</sup> where a significant number of penny stocks are also quoted. In the fall of 1999, the Electronic Quotation Service commenced an Internet-based, real-time quotation service that fostered increased transparency of securities quoted in the pink sheets.

Despite these moves toward increased transparency in the markets where penny stocks are quoted and traded, a persistent pattern of abuse continues to exist with regard to the trading of these low-priced, thinly traded securities.<sup>25</sup> Thus, increased transparency alone does not appear sufficient to provide investors with protection against the abusive practices often found in the penny stock market. As noted above, the Penny Stock Reform Act gave the Commission the authority to establish the criteria that national securities exchanges and automated quotation systems of registered national securities associations must meet in order to qualify securities for the exclusion from the term “penny stock.” In light of the last decade’s experience, we believe it is appropriate to take the measured step of providing an additional level of protection to investors in low-priced, thinly traded securities.

We are, therefore, proposing to amend the current exclusion for reported securities in paragraph (a) of Rule 3a51-1<sup>26</sup> to require that reported securities

<sup>24</sup> See Proposing Release at n. 15, 56 FR at 19169. Since June of 2000, the “pink sheets” have been published and distributed nationally by Pink Sheets LLC and, with the exception of the OTC Bulletin Board, are the principal interdealer quotation system for equity securities that are not listed on an exchange or quoted on the Nasdaq system.

<sup>25</sup> See, e.g., *SEC v. 800 America.com, Inc., et al.*, Litigation Rel. No. 17835 (Nov. 13, 2002); *SEC v. Eagle Building Technologies, Inc., and Anthony Damato*, Litigation Rel. No. 17803 (Oct. 23, 2002); *SEC v. Las Vegas Entertainment Network, Inc., Joseph A. Corazzi, Carl A. Sambus, and Jay I. Goldberg*, Litigation Rel. No. 17779 (Oct. 9, 2002); *SEC v. Camilo Pereira a/k/a Camilo Agasim-Pereira*, Litigation Rel. No. 17616 (July 16, 2002); *SEC v. Victor Industries, Inc., Ronald Pellett, Penny Sperry, and Xion, Inc.*, Litigation Rel. No. 17383 (Feb. 27, 2002); *SEC v. Mark E. Rice D/B/A Primex Capital*, Litigation Rel. No. 17377 (Feb. 25, 2002); *SEC v. Max C. Tanner, et al.*, Litigation Rel. No. 17305 (Jan. 14, 2002); *SEC v. Save The World Air, Inc.*, Litigation Rel. No. 17283 (Dec. 19, 2001); *SEC v. Spectrum Brands Corp., Saverio (Sammy) Galasso III, David Hutter (a/k/a David Green), Charlie Dilluvio and Michael Burns*, Litigation Rel. No. 17265 (Dec. 11, 2001); *SEC v. U.N. Dollars Corp., Harold F. Harris, Ronald E. Crews, Edward A. Durante (a/k/a Ed Simmons), Carib Securities Ltd., Berkshire Capital Partners, Inc., Galton Scott & Golett Inc., Dottenhoff Financial Ltd., Zimenn Importing and Exporting Inc., Prudential Overseas Company, Ltd., Commonwealth Associates, Ltd., Henry C. Weingarten, Defendants, and Exchange Bank & Trust, Inc., and VJV Inc., Relief Defendants*, Litigation Rel. No. 17177 (Oct. 11, 2001).

<sup>26</sup> 17 CFR 240.3a51-1(a).

satisfy one of the following standards in order to be excluded from the definition of penny stock. First, a reported security registered on a national securities exchange could qualify for the exclusion for reported securities if the national securities exchange on which it is registered has been continuously registered since April 20, 1992<sup>27</sup> and has maintained quantitative listing standards, both initial and continued, that are substantially similar to those that are in place at that exchange on January 8, 2004.<sup>28</sup> Second, a reported security registered on a national securities exchange could qualify for this exclusion, even if the national securities exchange on which it is registered has not been continuously registered since April 20, 1992, has not maintained the quantitative listing standards outlined above, or has established a “junior” tier, if the national securities exchange or “junior” tier has quantitative initial listing standards that meet or exceed the criteria set forth below and maintains continued listing standards reasonably related to its initial listing standards. Third, a reported security listed on an automated quotation system sponsored by a registered national securities association<sup>29</sup> could qualify for this exclusion if the registered national securities association has quantitative initial listing standards for the automated quotation system that meet or exceed the criteria set forth below and maintains quantitative continued listing standards reasonably related to

its initial listing standards.<sup>30</sup> We are also proposing to eliminate the exception in paragraph (a) of Rule 3a51–1.<sup>31</sup> Because the Emerging Company Marketplace no longer exists,<sup>32</sup> this exception is no longer necessary.

In addition, we are proposing to amend the exclusion for certain other exchange-registered securities provided by paragraph (e) of Rule 3a51–1<sup>33</sup> to require that these securities satisfy, in addition to the existing requirements of paragraph (e), one of the standards described above applicable to reported securities that are exchange-registered in order to be excluded from the definition of penny stock.<sup>34</sup> We are also proposing to amend the exception in paragraph (e) of Rule 3a51–1<sup>35</sup> to make clear that a security that satisfies the requirements of paragraph (e) and also satisfies the requirements of paragraphs (a), (b), (c), (d), (f) or (g) of Rule 3a51–1 is not a penny stock for purposes of Section 15(b)(6) of the Exchange Act.<sup>36</sup>

In order to qualify for the exclusion for reported securities or the exclusion for certain other exchange-registered securities, we are proposing that a

national securities exchange (other than a “grandfathered” exchange) or an automated quotation system sponsored by a registered national securities association on which the security is registered or listed must have quantitative initial listing standards that require issuers to have (1) either stockholders’ equity of at least \$5 million, or a market value of listed securities of \$50 million, or net income from continuing operations (in the most recently completed fiscal year or two of the last three most recently completed fiscal years) of \$750,000; and (2) an operating history of at least one year or a market value of listed securities of \$50 million. In addition, for common and preferred stock the listing standards must require a minimum bid price of \$4 per share. For common stock, the listing standards must also require at least 300 round lot holders, and at least 1,000,000 publicly held shares with a market value of at least \$5 million. In the case of a convertible debt security, the initial listing standards would need to require a principal amount outstanding of at least \$10 million. In the case of rights and warrants, the initial listing standards would also need to require that at least 100,000 rights and warrants be issued and that the underlying security would be listed on a national securities exchange or on an automated quotation system sponsored by a registered national securities association. In the case of put warrants (that is, instruments that grant the holder the right to sell to the issuing company a specified number of shares of the company’s common stock, at a specified price on or before a specified date), the initial listing standards would require there to be at least 100,000 put warrants issued and the underlying security to be listed on a national securities exchange or on an automated quotation system sponsored by a registered national securities association. In the case of units (that is, two or more securities traded together), the listing standards would require that all component securities meet the requirements for initial listing. Finally, the listing standards would require that all other equity securities listed on the national securities exchange or on the automated quotation system sponsored by a registered national securities association, *e.g.*, hybrid securities and derivative securities products, meet initial listing standards that are substantially similar to those outlined above.

These criteria are modeled on the quantitative criteria currently required by Nasdaq for inclusion in its SmallCap

<sup>27</sup> This is the date on which the Commission adopted Rule 3a51–1.

<sup>28</sup> We refer to this provision as a “grandfather” provision. The concept of “substantially similar” tracks the language of Section 18 of the Securities Act of 1933 [15 U.S.C. 77r(b)(1)(B)], as amended by the National Securities Markets Improvement Act of 1996, Pub. L. 104–290, 110 Stat. 3416 (1996). The Commission would interpret the phrase “substantially similar” in this context as it has in the context of Section 18. *See, e.g.*, Exchange Act Rel. No. 39542 (Jan. 13, 1998), 63 FR 3032 (Jan. 21, 1998) (in which the Commission concluded that the listing standards of the Chicago Board Options Exchange, Incorporated and Tier I of the Pacific Exchange, Incorporated and Tier I of the Philadelphia Stock Exchange, Incorporated were substantially similar to the listing standards of the New York Stock Exchange, Inc., the American Stock Exchange LLC and the Nasdaq/National Market System and adopted Rule 146(b) designating securities listed on these markets as “covered securities” for purposes of Section 18 of the Securities Act of 1933). *See* 17 CFR 230.146(b).

<sup>29</sup> We are proposing to use the term “automated quotation system,” which is the term Congress used in the Penny Stock Reform Act, to avoid tying the exclusion in paragraph (a) to any specific market sponsored by a registered national securities association. As a result, we believe the exclusion in paragraph (a) will have sufficient flexibility to keep pace with the evolution of markets. The term includes Nasdaq.

<sup>30</sup> We believe that the securities now listed on Nasdaq do not need a “grandfather” provision because the proposed quantitative listing standards are modeled on those currently used by the Nasdaq SmallCap Market.

<sup>31</sup> This exception provides that any security that is listed on the American Stock Exchange LLC pursuant to the listing criteria of the Emerging Company Marketplace, but that does not satisfy the requirements of paragraphs (b), (c), or (d) of Rule 3a51–1, is a penny stock solely for purposes of the penny stock bar provisions of Exchange Act Section 15(b)(6).

<sup>32</sup> *See* note 11, above.

<sup>33</sup> 17 CFR 240.3a51–1(e). *See* note 18, above, for a description of paragraph (e).

<sup>34</sup> As a result of these proposed changes to paragraphs (a) and (e) of Rule 3a51–1, regardless of whether the OTC Bulletin Board or any successor to the OTC Bulletin Board is operated by a national securities exchange or a registered national securities association, the OTC Bulletin Board or any successor to it must satisfy the initial and continued listing standards that we are proposing in order to qualify for either exclusion from the definition of penny stock. We note, however, that in proposing these amendments, the Commission is not expressing a view regarding the pending application for registration of Nasdaq as a national securities exchange.

<sup>35</sup> This exception currently provides that a security that satisfies the requirements of paragraph (e), but that does not otherwise satisfy the requirements of paragraphs (a), (b), (c), or (d) of Rule 3a51–1, is a penny stock solely for purposes of the penny stock bar provisions of Exchange Act Section 15(b)(6).

<sup>36</sup> Proposed new paragraph (f), discussed below, would provide an exclusion for security futures products. We believe that it would be appropriate to treat this new exclusion in the same way as the exception to paragraph (e) treats the exclusion for securities that are put or call options issued by the Options Clearing Corporation. The proposed inclusion of paragraph (g) is intended to clarify a potential ambiguity in the current rule, and it is not intended to be a substantive change to the current rule.

Market,<sup>37</sup> with the exception of the quantitative initial listing criteria for all other equity securities, including hybrid and derivative securities. This additional “general” initial listing standard is designed to ensure that all equity products listed on a qualifying exchange or on a qualifying automated quotation system sponsored by a registered national securities association, even those with features common to both equity and debt securities, would meet initial listing standards that are comparable to those applicable to more traditional equity securities.<sup>38</sup>

We believe that these proposed standards would create a more meaningful distinction between securities that should be subject to the penny stock rules and those of more substantially capitalized issuers. Listing standards serve as a means for national securities exchanges and registered national securities associations to screen issuers and provide listed status only to companies that meet standardized criteria. It is therefore appropriate that the exclusions from the definition of penny stock for reported securities and for certain other exchange-registered securities require exchanges and automated quotation systems sponsored by registered national securities associations to have minimum

quantitative initial listing standards, as well as reasonably related continued listing standards.

We request comment on patterning the proposed initial listing standards after those currently used by the SmallCap Market. Should other initial listing standards be used? If so, which ones and why? Should these proposed initial listing standards be extended to the exclusion for reported securities, or should they only be imposed on the exclusion contained in paragraph (e) for certain other exchange-registered securities? Commenters should explain their views. We also solicit comment regarding the proposal to require a “general” listing standard applicable to all other equity products listed on a qualifying exchange or a qualifying automated quotation system sponsored by a registered national securities association, even those with features common to both equity and debt securities. Should the proposed rule have such a general standard or not? Please explain any answer provided to this question. In addition, we request comment regarding any possible negative impact on small business capital formation. If there is an unintended negative impact on small business capital formation, is there an alternative that would protect investors, issuers and markets while avoiding these consequences?

We are also proposing that a national securities exchange (other than a “grandfathered” exchange) or an automated quotation system sponsored by a registered national securities association must establish quantitative continued listing standards that are reasonably related to the proposed initial listing standards discussed above and are consistent with the maintenance of fair and orderly markets<sup>39</sup> in order to qualify for the exclusion for reported securities or for the exclusion for certain other exchange-registered securities.<sup>40</sup> Once a security has been approved for initial listing, an exchange or an automated quotation system sponsored by a registered national securities association is required to monitor the status and trading characteristics of that issue to ensure it continues to satisfy the

continued listing criteria. Because listed companies are on-going businesses that are subject to changing markets and changing economic circumstances, we recognize that the continued listing standards will not be identical to the initial listing standards. Nevertheless, to meet the proposed requirement that they be reasonably related to the initial listing standards, the continued listing standards should be similar enough to the initial listing standards so that the continued listing standards have sufficient substance and meaning to uphold the quality of particular markets.

The Commission believes that requiring national securities exchanges (other than “grandfathered” exchanges) and registered national securities associations to adopt continued listing standards that are reasonably related to the proposed initial listing standards would help to ensure the stability of their respective markets, as well as protect investors, by enabling the exchanges and the registered national securities associations to identify listed companies that may not have sufficient liquidity and financial resources to warrant continued listing.

We solicit comment on the proposed continued listing standards discussed above. Commenters are encouraged to suggest alternative continued listing standards and criteria and to explain the advantages of their suggested alternative. Commenters are also encouraged to suggest appropriate modifications to these proposed amendments.

Finally, we wish to emphasize that we do not intend these proposals to disturb the status quo with respect to securities relying on the current exclusions from the definition of penny stock. In addition, we note that any security that satisfies one of the other exclusions in Rule 3a51-1 will not be a penny stock even if it fails to satisfy any of the proposed conditions for reported securities or for other exchange-registered securities discussed above.<sup>41</sup>

#### *B. Proposed Elimination of the Exclusion for Nasdaq Securities*

We are proposing to eliminate the current exclusion in paragraph (f) of Rule 3a51-1 for certain securities quoted or authorized for quotation upon notice of issuance on Nasdaq because

<sup>37</sup> See NASD Rule 4310(c). Due to the continued development of new markets and exchanges, we are proposing to base the proposed rules on the listing standards of the SmallCap Market. We have chosen this particular market because we believe its quantitative listing standards are sufficient to exclude those companies that pose the most danger to unsophisticated investors—companies that are minimally capitalized and that do not possess the attributes of companies with general market followings such as, for example, substantial tangible assets, an operating history, a defined business plan, net income, and genuine public interest as demonstrated by a large number of public shareholders that are not affiliated with the company or a significant market value for the company's listed shares. The companies listed in note 25, above, for example, could not have complied with the listing standards we are proposing. At the same time, we believe that these standards are not so strict as to inhibit legitimate capital formation or to prevent bona fide companies from having their securities registered and traded on national securities exchanges.

<sup>38</sup> Specifically, if an exchange or an automated quotation system of a registered national securities association plans to list or to trade, pursuant to unlisted trading privileges, a new derivative securities product or other hybrid securities product, it would need to have quantitative listing standards that are appropriate to that product and address the concerns the penny stock rules are designed to address to have that securities product excluded from the definition of penny stock. Apart from the requirements of Rule 3a51-1, however, the listing standards for such derivative securities products and other hybrid securities products must also address surveillance and trading rules as well as other concerns applicable to derivative and hybrid products. See Exchange Act Rel. No. 40761 (Dec. 8, 1998), 63 FR 70952 (Dec. 22, 1998).

<sup>39</sup> The continued listing standards must also satisfy the requirement under Section 6(b)(5) or 15A(b)(6) of the Exchange Act [15 U.S.C. 78f(b)(5) or 78o-3(b)(6)] that an exchange or a registered national securities association have rules that are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to, and perfect the mechanism of, a free and open market and, in general, to protect investors and the public interest. See, e.g., Exchange Act Rel. No. 45898 (May 8, 2002), 67 FR 34502 (May 14, 2002).

<sup>40</sup> See note 30, above.

<sup>41</sup> For example, under paragraph (g) of the current rule, a security is not a penny stock if its issuer has net tangible assets (*i.e.*, total assets less intangible assets and liabilities) in excess of \$2,000,000, if the issuer has been in continuous operation for at least three years, or \$5,000,000, if the issuer has been in continuous operation for less than three years; or has average annual revenues of at least \$6,000,000. See Rule 3a51-1(g).

we believe it no longer serves any purpose. When the Commission adopted the penny stock rules, Nasdaq National Market System securities were reported securities.<sup>42</sup> SmallCap Market securities, however, were not reported securities within the meaning of paragraph (a) of Rule 3a51-1.<sup>43</sup> Paragraph (f) of Rule 3a51-1 was intended to provide an exclusion for SmallCap Market securities. In 2001, the Commission issued an order that, among other things, explicitly recognized SmallCap Market securities as reported securities because they are securities reported pursuant to a transaction reporting plan approved by the Commission.<sup>44</sup> As a result, all securities quoted on Nasdaq are reported securities within the meaning of paragraph (a) of Rule 3a51-1 and are therefore excluded from the definition of penny stock on that basis. We request comment on the proposed deletion of this exclusion.

#### *C. Proposed New Exclusion for Security Futures Products*

We are also proposing to amend Rule 3a51-1 by adding proposed new paragraph (f), which would exclude from the definition of penny stock security futures products listed on a national securities exchange or an automated quotation system sponsored by a registered national securities association.<sup>45</sup> This would be consistent with the treatment of options under the penny stock rules. In particular, the term "penny stock" currently does not include any put or call option issued by the Options Clearing Corporation ("OCC").<sup>46</sup> This exclusion recognizes that the put and call options issued by the OCC are subject to special disclosure requirements.<sup>47</sup> Security futures products are subject to a similar disclosure regime. In particular, broker-dealers must provide their customers with a risk disclosure document before effecting transactions in security futures

products for their customers.<sup>48</sup> Subjecting security futures products to the additional disclosure requirements of the penny stock rules, therefore, would likely be duplicative and unnecessarily burdensome. We request comment on the proposed exclusion of security futures products from the definition of penny stock.

We note that security futures products commenced trading on November 8, 2002.<sup>49</sup> We are, therefore, issuing an order pursuant to Exchange Act Section 36<sup>50</sup> temporarily exempting security futures products from the definition of penny stock until such time as the Commission takes any further action on this proposed amendment to Rule 3a51-1.<sup>51</sup> This exemptive period will allow the Commission to receive and consider comments while, at the same time, temporarily excluding security futures products from the penny stock rules.

#### **IV. Background Regarding the Proposed Amendments to Rules 15g-2 and 15g-9**

We also propose amending Exchange Act Rules 15g-2 and 15g-9.<sup>52</sup> These rules essentially require that before a broker-dealer effects a transaction in a penny stock for a customer, the broker-dealer must provide the customer with certain disclosure documents and receive, in tangible form, both a signed acknowledgement of receipt of those documents and an agreement to the particular transaction. These requirements give customers the opportunity to carefully consider whether an investment in a penny stock that is recommended by a broker-dealer is appropriate for them.

The Commission is concerned that this "stop and think" opportunity could be unintentionally eroded by changes in technology coupled with the effect of the Electronic Signatures in Global and National Commerce Act ("Electronic Signatures Act").<sup>53</sup> In relevant part, the Electronic Signatures Act, which was signed into law on June 30, 2000, established that no signature, contract or other record relating to a transaction in interstate or foreign commerce may be

denied legal effect, validity, or enforceability solely because it is in electronic form.<sup>54</sup>

Since the penny stock rules were adopted, electronic commerce has become commonplace. The Internet now allows investors to execute securities transactions virtually instantaneously. While this technology has provided investors with many benefits and opportunities, when considered in light of the Electronic Signatures Act, it has the potential to undermine the effectiveness of the penny stock rules. The amendments we are proposing to Rules 15g-2 and 15g-9 attempt to strike a balance by facilitating the use of electronic communications as contemplated by the Electronic Signatures Act while maintaining the important investor protections of the Penny Stock Reform Act. These amendments would explicitly retain the time for consideration that was inherent in the rules at the time they were adopted in light of then-current technology. The proposed rule amendments would preserve investors' opportunity to consider their investment decisions to purchase penny stocks outside of a high-pressure environment, and thus are designed to ensure that evolving technological advances and the legislative response to these advances do not inadvertently erode these protections.

The legislative history of the Electronic Signatures Act suggests that Congress expected the Commission to help ensure that the protections afforded under the penny stock rules remained intact after the Act went into effect.<sup>55</sup> Moreover, the Electronic

<sup>54</sup> Electronic Signatures Act, Sec. 101(a)(1), 15 U.S.C. 7001(a)(1).

<sup>55</sup> The following colloquy took place on the floor of the House between Chairman Bliley and Representative Markey:

Mr. MARKEY. Mr. Speaker, on another matter, with respect to penny stocks, would the gentleman from Virginia agree that conference reports preserve the ability of the SEC to require written customer statements with respect to a purchase of penny stocks, as was required in the House-passed version of this bill?

Mr. BLILEY. Mr. Speaker, if the gentleman will yield, the gentleman from Massachusetts is correct. Following enactment of the Penny Stock Reform Act of 1990, the SEC has developed a cold call rule that requires brokers to obtain a signed customer statement regarding any penny stock to be purchased before any transaction takes place. In addition, customers are provided with important written disclosures involving risks of investing in penny stocks. Section 104 of the conference report specifically permits Federal regulatory agencies, such as the SEC, to interpret the law to require retention of written records in paper form if there is a compelling governmental interest in law enforcement for imposing such a requirement and if imposing such a requirement is essential to attaining such interest. The conferees expect the

<sup>42</sup> See Adopting Release, 57 FR at 18004.

<sup>43</sup> *Id.* at 57 FR at 18008.

<sup>44</sup> See Exchange Act Rel. No. 45081 at n. 36 (Nov. 19, 2001), 66 FR 59273 (Nov. 27, 2001).

<sup>45</sup> Section 6(h)(1) of the Exchange Act makes it unlawful for any person to effect transactions in security futures products that are not listed on a national securities exchange or a national securities association registered pursuant to section 15A(a). 15 U.S.C. 78f(h)(1).

<sup>46</sup> 17 CFR 240.3a51-1(c).

<sup>47</sup> Adopting Release at n. 39, 57 FR at 18010 ("In addition, because put and call options issued by the OCC are already subject to special disclosure requirements, they are separately excluded from the definition of penny stock in paragraph (c) of Rule 3a51-1."). See also 17 CFR 240.9b-1; CBOE Rules 9.1-9.23; NASD Rule 2860(b)(16).

<sup>48</sup> See Exchange Act Rel. No. 46862 (Nov. 20, 2002), 67 FR 70993 (Nov. 27, 2002); Exchange Act Rel. No. 46614 (Oct. 7, 2002), 67 FR 64162 (Oct. 17, 2002). See also NASD Rule 2865(b)(1) and NFA Compliance Rule 2-30(b).

<sup>49</sup> Peter A. McKay, *Single Stock Futures Arrive in the U.S. With Room to Grow*, Wall Street Journal, Nov. 11, 2002, at B6.

<sup>50</sup> 15 U.S.C. 78mm(a)(1).

<sup>51</sup> See Exchange Act Rel. No. 34-49038 (January 8, 2004).

<sup>52</sup> 17 CFR 240.15g-2 and 240.15g-9.

<sup>53</sup> Electronic Signatures in Global and National Commerce Act, Pub. L. 106-229, 114 Stat. 464 (2000) (codified at 15 U.S.C. 7001 *et seq.* (2001)).

Signatures Act permits Federal regulatory agencies, such as the Commission, to interpret and apply the Act in the context of their particular regulatory schemes.<sup>56</sup> In addition, the Electronic Signatures Act provides Federal regulatory agencies with limited ability to require retention of a record in a tangible printed or paper form if (i) “there is a compelling governmental interest relating to law enforcement or national security for imposing such requirement” and (ii) “imposing such requirement is essential to attaining such interest.”<sup>57</sup>

As described below, the disclosures and customer signatures required in tangible form under current Rules 15g–2 and 15g–9 have proven to be an effective means to implement the intent of Congress in enacting the Penny Stock Reform Act and achieve the Commission’s goal of protecting investors. The proposed rule amendments are intended to provide the same protections to penny stock customers regardless of how they communicate with their broker-dealers.

#### A. Current Requirements Under Rules 15g–2 and 15g–9

##### 1. Rule 15g–2

Rule 15g–2(a)<sup>58</sup> makes it unlawful for a broker-dealer to effect a transaction in a penny stock with or for the account of

SEC would be able to use this provision to require brokers to keep written records of all disclosures and agreements required to be obtained by the SEC’s penny stock rule.

Mr. MARKEY. Mr. Speaker, without question, penny stocks are a very special category of extremely dangerous investments that I think will require that the SEC needs to be able to ensure additional disclosure and agreements to continue to be done in writing to help protect consumers against fraud and facilitate the SEC securities law enforcement mission. I thank the gentleman from Virginia (Mr. Bliley) very much for his assistance.

146 Cong. Rec. H4360–61 (daily ed. June 14, 2000) (emphasis added).

<sup>56</sup> Electronic Signatures Act Sec. 104(b)(1)(A), 15 U.S.C. 7004(b)(1)(A).

<sup>57</sup> Electronic Signatures Act, Sec. 104(b)(3)(B), 15 U.S.C. 7004(b)(3)(B). The Commission is not addressing whether the documents required to be obtained from customers under the penny stock rules, if obtained electronically, must be maintained in a tangible printed or paper form for purposes of these proposed rule amendments.

<sup>58</sup> Rule 15g–2 provides:

(a) It shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless, prior to effecting such transaction, the broker or dealer has furnished to the customer a document containing the information set forth in Schedule 15G, 17 CFR 240.15g–100, and has obtained from the customer a manually signed and dated acknowledgement of receipt of the document.

(b) The broker or dealer shall preserve, as part of its records, a copy of the written acknowledgment required by paragraph (a) of this section for the period specified in 17 CFR 240.17a–4(b) of this chapter.

a customer unless the broker-dealer distributes to the customer, prior to effecting a transaction in a penny stock, a document, as set forth in Schedule 15G,<sup>59</sup> and receives a signed and dated acknowledgement of receipt of that document from the customer in tangible form.<sup>60</sup> The document, which must contain the information set forth in Schedule 15G (“penny stock disclosure document”), gives several important warnings to investors concerning the penny stock market, and cautions investors against making a hurried investment decision. Among other things, the penny stock disclosure document points out that salespersons are not impartial advisers, that investors should compare information from the salesperson with other information on the penny stock, and that salespersons may not legally state that a stock will increase in value or guarantee against loss.<sup>61</sup>

When we adopted Rule 15g–2, we requested comment on whether the penny stock disclosure document should be required to be executed and returned by the customer, prior to the customer’s first transaction in a penny stock with the broker-dealer, in order to evidence compliance with the rule.<sup>62</sup> In response to comments received, the Commission amended Rule 15g–2 in 1993 to require a broker-dealer to obtain an acknowledgement from the customer that he or she has received the penny stock disclosure document prior to effecting transactions for the customer in penny stocks.<sup>63</sup> As we stated at the time, “[t]he requirement to obtain the customer’s signature is intended to

<sup>59</sup> 17 CFR 240.15g–100 (“Information to be included in the document distributed pursuant to 17 CFR 240.15g–2”). This disclosure document provides the customer with information and warnings about the risky nature of penny stocks, details the disclosures that the broker-dealer is required to give to the customer, and contains information concerning brokers’ duties and customers’ rights and remedies.

<sup>60</sup> Rule 15g–2(a) [15 CFR 240.15g–2(a)] provides “(a) It shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless, prior to effecting such transaction, the broker or dealer has furnished to the customer a document containing the information set forth in Schedule 15G, 17 CFR 240.15g–100, and has obtained from the customer a manually signed and dated written acknowledgement of receipt of the document.”

<sup>61</sup> *Id.* See also Adopting Release, 57 FR at 18018.

<sup>62</sup> Adopting Release, 57 FR at 18031. This would enable broker-dealers to demonstrate compliance with the rule as well as enable regulators to examine for a broker-dealer’s compliance with the rule.

<sup>63</sup> In addition, the broker-dealer must maintain that record for at least three years following the date on which the penny stock disclosure document was provided to the customer. See Rule 15g–2(b) [17 CFR 240.15g–2(b)]. During the first two years, the penny stock disclosure document must be in an accessible place.

emphasize to customers the importance of making an informed and deliberate investment decision.”<sup>64</sup>

It is important to note, however, that Rule 15g–2 is narrowly focused to protect retail investors against the types of abusive and fraudulent sales practices that Congress considered in enacting the Penny Stock Reform Act—“boiler room” sales tactics and so-called “pump and dump” schemes by penny stock market makers. For example, the obligation to provide the penny stock disclosure document does not apply when the broker-dealer has not been a market maker in the particular penny stock that it is recommending during the immediately preceding twelve months and has not received more than five percent of its commissions and certain other revenue from transactions in penny stocks during each of the preceding three months.<sup>65</sup> Similarly, transactions with institutional accredited investors are not subject to many of the penny stock rules, including the requirement that the broker-dealer provide the penny stock disclosure document to a customer and receive a signed acknowledgement of receipt of that document from that customer under Rule 15g–2.<sup>66</sup>

In addition, the obligation to provide a penny stock disclosure document does not apply where the penny stock transaction was not recommended by the broker-dealer.<sup>67</sup> Therefore, nothing in this rule precludes a broker or dealer in penny stocks from immediately executing an unsolicited transaction at a customer’s request. Rather, it is focused on protecting unwary investors who may be faced with fraudulent and high-pressure sales tactics by brokers and dealers recommending and selling penny stocks in which they are making markets.

##### 2. Rule 15g–9

Rule 15g–9, which was originally adopted as Rule 15c2–6 under the

<sup>64</sup> Exchange Act Rel. No. 32576 (July 2, 1993), 58 FR 37413, 37416 (July 12, 1993). See also Schedule 15G to the penny stock rules, 17 CFR 240.15g–100. In fact, the Commission amended the penny stock disclosure document set forth in Schedule 15G to specifically urge investors to consider the warnings and other information in the document before providing the signed acknowledgement of receipt to their broker-dealers, as follows:

“Important Information on Penny Stocks  
This statement is required by the U.S. Securities and Exchange Commission (SEC) and contains important information on penny stocks. Your broker-dealer is required to obtain your signature to show that you have received this statement before your first trade in a penny stock. You are urged to read this statement before signing and before making a purchase or sale of a penny stock.”

<sup>65</sup> Rule 15g–1(a) [17 CFR 240.15g–1(a)].

<sup>66</sup> See Rule 15g–1(b) [17 CFR 240.15g–1(b)].

<sup>67</sup> Rule 15g–1(e) [17 CFR 240.15g–1(e)].



Exchange Act, was designed to address sales practice abuses involving certain speculative low-priced securities being traded in the non-Nasdaq over-the-counter ("OTC") market.<sup>68</sup> As the Commission noted in adopting the Rule, "[t]he target of the Rule is sales practice abuse and manipulation, not small issuers or speculative investment decisions *per se*. It is, however, in [penny stocks] that the Commission has found that a disproportionate number of such abuses occur, and it is for this reason that the Commission is adopting a prophylactic rule for recommended sales of such securities."<sup>69</sup> Rule 15g-9 generally prohibits a broker-dealer from selling to, or effecting the purchase of a penny stock by, any person unless the broker-dealer has approved the purchaser's account for transactions in penny stocks and received the purchaser's agreement in tangible form to the transaction.

In approving an account for transactions in penny stocks, a broker-dealer must obtain sufficient information from the customer to make an appropriate suitability determination, provide the customer with a statement setting forth the basis of the determination, and obtain a signed copy of the suitability statement from the customer in tangible form.<sup>70</sup> By

requiring the customer to agree in tangible form to purchases of penny stocks, Rule 15g-9(a)(2)(ii) was intended to provide the customer with an opportunity to make an investment decision outside of a high-pressure telephone conversation with a salesperson. It removes the pressure for an immediate decision.<sup>71</sup> We believe this requirement is critical to the effectiveness of the Rule.<sup>72</sup>

section and any other information known by the broker-dealer, that transactions in penny stocks are suitable for the person, and that the person \* \* \* reasonably may be expected to be capable of evaluating the risks of transactions in penny stocks;

(3) deliver to the person a written statement:

(i) setting forth the basis on which the broker or dealer made the determination required by paragraph (b)(2) of this section;

(ii) stating in a highlighted format that it is unlawful for the broker or dealer to effect a transaction in a penny stock subject to the provisions of paragraph (a)(2) of this section unless the broker or dealer has received, prior to the transaction, a written agreement to the transaction from the person; and

(iii) stating in a highlighted format immediately preceding the customer signature line that:

(A) the broker or dealer is required by this section to provide the person with the written statement; and

(B) the person should not sign and return the written statement to the broker or dealer if it does not accurately reflect the person's financial situation, investment experience, and investment objectives; and

(4) obtain from the person a manually signed and dated copy of the written statement required by paragraph (b)(3).

<sup>71</sup> As the Commission noted when it adopted Rule 15c2-6:

Most of the sales practice abuses involving low-priced securities are conducted over the telephone by broker-dealers engaging in "boiler-room" operations. Improved communications technology has enabled an increasing number of this type of broker-dealer to engage in high-pressure sales campaigns on a nationwide basis. An essential aspect of a boiler-room operation is the use of numerous salespersons making hundreds of high-pressure cold calls each day to generate sales of low-priced securities to new customers. Cold calls are telephone calls made to persons whose names are drawn from a telephone directory or a membership list. Consequently, many of the persons called will have little investment experience and limited financial resources. The salespersons are trained in high-pressure sales tactics designed to elicit a buy decision during the course of a telephone call, and typically are compensated solely by commissions generated by sales of securities. Because many of the persons called are inexperienced investors, they are particularly vulnerable to deceptive sales pitches promising high profits made by salespersons willing to disregard the unsuitability of a security for the purchaser.

Moreover, in a resolution supporting the adoption of the rule in 1989, the North American Securities Administrators Association stated that "penny stock manipulation schemes and fraudulent cold calling sales tactics are among the most prevalent fraudulent schemes being perpetrated on the investing public, resulting in millions of dollars of losses annually, damaging the efficient operation of the market and reducing the amount of capital available to legitimate business."

Exchange Act Rel. No. 27160, 54 FR at 35469.

<sup>72</sup> As the Commission stated when it adopted Rule 15c2-6:

In addition, the requirement that the broker-dealer provide a copy of its suitability determination to the customer prior to the customer's commitment to purchase a penny stock was intended to provide the customer with the opportunity to review that determination and decide whether the broker-dealer had made a good faith attempt to consider the customer's financial situation, investment experience and investment objectives.<sup>73</sup> The requirement that the broker-dealer receive a signed copy of the suitability statement in tangible form is also intended "to convey to the customer the importance of the suitability statement, and to prevent a salesperson from convincing the customer to sign the statement without a review for accuracy."<sup>74</sup>

Nevertheless, as with Rule 15g-2, these requirements under Rule 15g-9 do not apply to all broker-dealers or in all cases involving transactions in penny stocks. Most notably, none of these provisions applies to broker-dealers that have not received more than five percent of their commissions and certain other revenue from transactions in penny stocks during each of the preceding three months and have not made a market in the penny stock to be purchased by the customer during the preceding twelve months. Moreover, they do not apply when the customer is an institutional accredited investor or when the broker-dealer did not recommend to the customer the penny stock to be purchased.<sup>75</sup> In addition, the provisions of Rule 15g-9 do not apply if the customer is an "established customer" of the broker-dealer; that is, if the customer has had an account with the broker-dealer in which the customer (1) has effected a securities transaction or deposited funds more than one year previously, or (2) has already made three purchases involving different penny stocks on different days.<sup>76</sup>

"The written agreement requirement provides the Rule's most direct protection against high-pressure sales tactics by enhancing the ability of investors to guard themselves against such tactics. Broker-dealers involved in boiler room abuses typically use prepared scripts designed by marketing experts that try to elicit immediate buy decisions during the course of one or a series of telephone calls. \* \* \* The written agreement requirement has the beneficial effect of ensuring that the customer's final decision will be made outside of a pressuring telephone call, and of providing objective evidence of whether a customer has agreed to a transaction."

Exchange Act Rel. No. 27160, 54 FR at 35480.

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*, 54 FR at 35479.

<sup>75</sup> See Rule 15g-9(c)(1) [17 CFR 240.15g-1], referencing Rules 15g-1(b) and (e) [17 CFR 240.15g-1(b), (e)].

<sup>76</sup> See Rules 15g-9(c)(3) and 15g-9(d)(2) [17 CFR 240.15g-9(c)(3) and 240.15g-9(d)(2)].

<sup>68</sup> Exchange Act Rel. No. 27160, 54 FR at 35468. The rule was redesignated as Rule 15g-9 in Exchange Act Rel. No. 32576. As we stated in adopting Rule 15c2-6, "[t]he Commission is taking this action in response to the widespread incidence of misconduct by some broker-dealers in connection with transactions in low-priced securities." Exchange Act Rel. No. 27160, 54 FR at 35468. Furthermore, "[c]ommenters supporting the proposed rule particularly noted the seriousness and extent of broker-dealer misconduct in the market for low-priced, non-NASDAQ OTC securities, and the need for effective regulatory tools with which to address such misconduct." Exchange Act Rel. No. 27160, 54 FR at 35469.

<sup>69</sup> Exchange Act Rel. No. 27160, 54 FR at 35479.

<sup>70</sup> Rule 15g-9 provides, in pertinent part:

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for a broker or dealer to sell a penny stock to, or to effect the purchase of a penny stock by, any person unless:

(1) The transaction is exempt under paragraph (c) of this section; or

(2) prior to the transaction:

(i) the broker or dealer has approved the person's account for transactions in penny stocks in accordance with the procedures set forth in paragraph (b) of this section; and

(ii) the broker or dealer has received from the person a written agreement to the transaction setting forth the identity and quantity of the penny stock to be purchased.

(b) In order to approve a person's account for transactions in penny stocks, the broker or dealer must:

(1) Obtain from the person information concerning the person's financial situation, investment experience, and investment objectives;

(2) reasonably determine, based on the information required by paragraph (b)(1) of this



Thus, these disclosures are essentially required only in very narrow circumstances—when the customer is a relatively new customer of the penny stock market-making broker-dealer or has limited experience with penny stocks and is not an institutional accredited investor, and when the broker-dealer has solicited the customer to engage in a penny stock transaction. The investors whose transactions do not qualify for any of the exemptions to the application of the penny stock rules are the persons most in need of the protections afforded by the proposed rule amendments, including an opportunity for unpressured consideration of the risks inherent in penny stocks.

#### *B. The Need To Maintain These Investor Protections*

The Commission has long worked to integrate the use of electronic media into the delivery and disclosure requirements under the federal securities laws. We first published our views on the use of electronic media to deliver information to investors in 1995.<sup>77</sup> The 1995 Release focused on electronic delivery of prospectuses, annual reports to security holders and proxy solicitation materials under the Securities Act of 1933,<sup>78</sup> the Exchange Act<sup>79</sup> and the Investment Company Act of 1940.<sup>80</sup> Our 1996 electronic media release<sup>81</sup> focused on electronic delivery of required information by broker-dealers (including municipal securities dealers) and transfer agents under the Exchange Act and investment advisers under the Investment Advisers Act of 1940.<sup>82</sup> In March 1998, we summarized our views about the reach of U.S. securities laws to offers and sales of securities and investment services by means of the Internet—particularly offers and sales that purport to be effected offshore.<sup>83</sup> In April 2000, we provided guidance on the use of electronic media by securities issuers of all types, including operating

companies, investment companies and municipal securities issuers, as well as market intermediaries.<sup>84</sup> In addition, we have modified broker-dealer and investment adviser registration filing requirements to facilitate electronic filing, maintenance of and access to registration information over the Internet.<sup>85</sup> We have also provided guidance regarding the electronic storage of broker-dealer records in light of the Electronic Signatures Act.<sup>86</sup> We remain committed to adapting our regulations, as needed, to take into account technological advances in communications while seeking to ensure that investor protections are maintained.<sup>87</sup>

In our effort to integrate the use of electronic media into the federal securities laws, we addressed the penny stock rules in our 1996 Release.<sup>88</sup> Although the Commission allowed broker-dealers to meet their delivery obligations under the penny stock rules by electronic means, the Commission specifically determined that broker-dealers should continue to obtain from customers signatures and agreements in

tangible form under the penny stock rules.<sup>89</sup> We thus preserved the customer's ability to "stop and think," maintaining an important component of the investor protections of the penny stock rules.

As discussed above, the Electronic Signatures Act is intended to facilitate the use of electronic communications in interstate commerce. The Penny Stock Reform Act, on the other hand, was intended to provide protections to investors in penny stocks and address the fraudulent sales practices that had long characterized the markets for penny stocks. As mandated by Congress, the Commission adopted the penny stock rules in order to further the goals of the Penny Stock Reform Act. Implementation of the provisions of the Electronic Signatures Act in the context of the penny stock rules, however, requires us to harmonize the Congressional mandates.<sup>90</sup> The proposed amendments to Exchange Act Rules 15g-2 and 15g-9 attempt to do so.

The requirements that a customer provide, in tangible form, a signed copy of the suitability statement and an agreement for a particular transaction under Rule 15g-9, together with the requirement that customers provide, in tangible form, a signed copy of the penny stock disclosure document pursuant to Rule 15g-2, were designed to give investors time to reflect. This interval can be used by an investor to consider whether an investment in penny stocks, which is often a risky investment, is appropriate for him or her before the broker-dealer that actively solicited the investment effects a transaction. The proposed amendments to Rules 15g-2 and 15g-9 are intended to maintain an investor's ability to thoughtfully consider investment in penny stocks—even when communicating nearly instantaneously by means of electronic media—by imposing a two-business-day waiting period, as explained below. The two-

<sup>77</sup> Securities Act Rel. No. 7233 (Oct. 6, 1995), 60 FR 53458 (Oct. 13, 1995) (the "1995 Release").

<sup>78</sup> 15 U.S.C. 77a, *et seq.*

<sup>79</sup> 15 U.S.C. 78a, *et seq.*

<sup>80</sup> 15 U.S.C. 80a-1, *et seq.*

<sup>81</sup> Exchange Act Rel. No. 37182 (May 9, 1996), 61 FR 24644 (May 15, 1996) (the "1996 Release"). The 1996 Release also provided additional examples supplementing the guidance in the 1995 Release. Since 1996, we have further addressed the use of electronic media in the context of offshore sales of securities and investment services, *see* Securities Act Rel. No. 7516 (Mar. 23, 1998), 63 FR 14806 (Mar. 27, 1998) (the "1998 Release"), and cross-border tender offers, *see* Securities Act Rel. No. 7759, (Oct. 22, 1999), 64 FR 61382 (Nov. 10, 1999) (the "1999 Release").

<sup>82</sup> 15 U.S.C. 80b-1, *et seq.*

<sup>83</sup> 1998 Release.

<sup>84</sup> Exchange Act Rel. No. 42728 (Apr. 28, 2000), 65 FR 25843, 25844 (May 4, 2000) (As we stated at that time, "[t]he increased availability of information through the Internet has helped to promote transparency, liquidity and efficiency in our capital markets.").

<sup>85</sup> *See* Exchange Act Rel. No. 41594 (July 2, 1999), 64 FR 37586 (July 12, 1999), in which we amended Form BD, the uniform broker-dealer registration form, and related rules under the Exchange Act to support electronic filing in the Internet-based Central Registration Depository system; and Investment Advisers Act Rel. No. 1897 (Sept. 12, 2000), 65 FR 57438 (Sept. 22, 2000), in which we adopted new rules and rule amendments under the Investment Advisers Act of 1940 to require that advisers registered with the Commission make filings under the Act with the Commission electronically through the Investment Adviser Registration Depository, as well as amendments to Forms ADV and ADV-W.

<sup>86</sup> Exchange Act Rel. No. 44238 (May 1, 2001), 66 FR 22916 (May 7, 2001).

<sup>87</sup> *See* Exchange Act Rel. No. 44227 (Apr. 27, 2001), 66 FR 21648 (May 1, 2001) (amending the transfer agent record retention rule, Rule 17Ad-7, to allow registered transfer agents to use electronic, microfilm, and microfiche records maintenance systems to preserve records that they are required to retain under Rule 17Ad-6); Investment Advisers Act Rel. No. 1945 (May 24, 1995), 66 FR 30311 (June 6, 2001) (adopting rule amendments that expand the circumstances under which registered investment companies and registered investment advisers may keep records on electronic storage media). *See also* Securities Act Rel. No. 7877 (July 27, 2000), 65 FR 47281 (Aug. 2, 2000) (adopting, at the explicit direction of Congress in Section 104(d)(2) of the Electronic Signatures Act, Securities Act Rule 160, which exempts from the consumer consent requirements contained in Section 101(c) of the Electronic Signatures Act prospectuses of registered investment companies that are used for the sole purpose of permitting supplemental sales literature to be provided to prospective investors).

<sup>88</sup> *See* 1996 Release at n. 12 and n. 50, 61 FR at 24646 and 24649.

<sup>89</sup> *See* 1996 Release at n. 12, 61 FR at 24646 ("[T]he Commission believes that in order to fulfill the purposes of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, broker-dealers should continue to have customers manually sign and return in paper form any documents that require a customer's signature or written agreement.").

<sup>90</sup> We express no view regarding how the Electronic Signatures Act affects the federal securities laws other than with respect to the effect of Section 101(a) of the Act on the ability of broker-dealers to obtain from customers signatures and agreements in electronic form to satisfy the requirements of Exchange Act Rule 15g-9 that customers provide a signed and dated copy of the suitability statement and an agreement for a particular transaction, and the Rule 15g-2 requirement that customers provide a signed and dated acknowledgement of receipt of the penny stock disclosure document.

business-day waiting period is meant, as a practical matter, to replicate the interval investors had when we adopted the penny stock rules and that we maintained in the 1996 Release.

As noted above, this opportunity for careful consideration continues to be necessary today.<sup>91</sup> Although the efforts of Congress and the Commission, as well as other federal and state regulators, have targeted fraudulent activity in the market for penny stocks, penny stock fraud continues to victimize investors.<sup>92</sup> The proposed amendments to Rules 15g-2 and 15g-9 are intended to give investors the time to carefully consider—and, perhaps reject—the overtures of high-pressure broker-dealers, regardless of the media through which they transact business. As Congress recognized when it enacted the Penny Stock Reform Act, the defrauded victims of penny stock fraud activities are not the only ones harmed. Penny stock fraud is detrimental to the integrity of our nation's capital markets.

#### V. Proposed Amendments to Rules 15g-2 and 15g-9

The ongoing advances in technology, including widespread use of the Internet, e-mail and the ability to use electronic signatures may unintentionally weaken the investor protections intended by Congress in enacting the Penny Stock Reform Act and afforded under the penny stock rules. As discussed above, Section 101(a) of the Electronic Signatures Act enables customers to provide to broker-dealers in penny stocks electronic signatures in place of the signatures in tangible form required under Rules 15g-2(a) and 15g-9(b)(4), and permits customers to provide the agreement regarding particular penny stock transactions required under Rule 15g-9(a)(2)(ii) through electronic media.

<sup>91</sup> Unfortunately, the types of abuses that the Penny Stock Reform Act and the penny stock rules are intended to combat have a long history in the securities markets. In 1697, the Parliament of England passed “[a]n act to restrain the number and ill practice of brokers and stock jobbers.” The statute was aimed at unlawful conspiracies by jobbers to manipulate prices, and it followed a report of a special commission that had complained:

“The pernicious Art of Stock-jobbing hath, of late, so wholly perverted the End and Design of Companies and Corporations, erected for the introducing, or carrying on, of Manufacturers, to the private Profit of the first Projectors, that Privileges granted to them have, commonly, been made no other Use of, by the First Procurers and Subscribers, but to sell again, with Advantage, to ignorant Men, drawn in by the Reputation, falsely raised, and artfully spread concerning the thriving State of their Stock.”—Louis Loss and Joel Seligman, *Securities Regulation*, 3 (3d ed. 1989).

<sup>92</sup> See discussion above at Section III, A.

In the 1996 Release, while the Commission specifically determined that broker-dealers should continue to obtain signatures and agreements in tangible form under the penny stock rules instead of using electronic media to satisfy these requirements, the Commission also stated that it “may be willing to consider a ‘cooling-off’ period as an alternative to the requirement of a manual signature under Rules 15g-2 and 15g-9” when it next reviewed the penny stock rules,<sup>93</sup> and requested comment on the “cooling-off” period approach.<sup>94</sup> The one commentator addressing that aspect of the 1996 Release stated, without expressing a view as to investors’ need for such protection, that “a cooling off period would be a more appropriate means of regulation than withholding access to modern means of communication.”<sup>95</sup> In light of the intersection of the Electronic Signatures Act with the Penny Stock Reform Act and the penny stock rules, and the continued existence of fraudulent sales practices in the markets, we are proposing to implement such “cooling off” or waiting periods.

The proposed amendments would provide the method for compliance with current Rules 15g-2 and 15g-9(a) and (b) for brokers and dealers in penny stocks whose customers provide them with electronically signed or transmitted documents required under the Commission’s penny stock rules. Our proposal takes into account that, although we previously have interpreted the penny stock rules to prohibit the use of electronic media to satisfy certain requirements, the Electronic Signatures Act allows these requirements to be satisfied through electronic means. Customers using electronic media, however, could effectively lose some of the protections afforded by the penny stock rules. We believe the proposed amendments are necessary so that all investors continue to receive the protections that the penny stock rules were designed to provide.

In particular, we propose to impose a waiting period of two business days from the time the broker-dealer sends the required material to the customer regardless of whether these communications are paper-based or electronic. For example, as applied to Rule 15g-2(a), the proposed

amendments would impose a uniform waiting period of two business days that could be satisfied by waiting two days after sending the penny stock disclosure document required by the rule electronically or by mail or some other paper-based means. Similar time periods also would apply to the suitability statement required by Rule 15g-9(b) and the agreement to a transaction in a penny stock required by Rule 15g-9(a)(2)(ii). In other words, under the proposed amendments a broker-dealer could not execute the relevant penny stock transaction until at least two business days after it had transmitted the documents electronically or placed them in the mail. The rule would continue to require that the broker-dealer receive these signed documents, in either electronic<sup>96</sup> or paper form, back from the customer before executing the transaction.<sup>97</sup> Thus, the proposed amendments establish a two-business-day waiting period for all penny stock transactions during which a broker-dealer cannot sell a penny stock to a customer he or she has solicited even if the customer, either electronically or on paper, has signed and returned the documents required by the penny stock rules. The proposed amendments essentially seek to preserve parity between electronic and paper communications in the context of the disclosure requirements of the penny stock rules.

As discussed in detail below, we are also proposing to revise the penny stock disclosure document required by Rule 15g-2. As part of this revision, we are proposing to add the Internet address of that section of the Commission’s Web site that provides investors with information regarding microcap securities, including penny stocks. New paragraph (d) of Rule 15g-2 would require broker-dealers to send a copy of this section of the Commission’s Web site to any penny stock customer upon the customer’s request.

We solicit comment on the proposed amendments to Rules 15g-2 and 15g-9. Because the proposed amendments would not differentiate between electronic and paper-based transactions, all broker-dealers subject to the penny

<sup>96</sup> We note that an electronic acknowledgement of receipt generated automatically by certain e-mail programs when an e-mail message is delivered or opened would not satisfy any of these requirements.

<sup>97</sup> The proposed amendments would require that the broker-dealer continue to receive (i) a signed and dated acknowledgement of the receipt of the penny stock penny stock disclosure document from a customer under Rule 15g-2(a); (ii) a signed and dated suitability statement as required under Rule 15g-9(b); and (iii) an agreement to a transaction in a penny stock as required by Rule 15g-9(a)(2)(ii).

<sup>93</sup> *Id.* at n. 50, 61 FR at 24649.

<sup>94</sup> *Id.*

<sup>95</sup> Letter from Scuscommittee on Disclosure Technology of the Federal Regulation of Securities Committee of the Section of Business Law of the American Bar Association, to Jonathan G. Katz, Secretary, Securities and Exchange Commission, dated June 27, 1996, Re: Release No. 33-7288, File No. S7-13-96.

stock rules may be required to adjust the manner in which they currently comply with Rules 15g-2 and 15g-9. We therefore solicit comment on the costs, if any, broker-dealers would expect to incur in making these adjustments.

We also solicit comment on whether the proposed amendments could create any competitive advantages or disadvantages to particular firms or types of firms in this segment of the market. If so, commenters should explain these advantages or disadvantages in detail, and, if possible, quantify any associated costs. We also request comment on whether commencing the two-business-day waiting period at the time the documents are sent is the optimal starting point, or whether another starting point should be used. For example, should the waiting period commence when the broker-dealer receives the document back from the customer? Should the waiting period be three business days instead of two business days?<sup>98</sup> Should the waiting period be measured in calendar days instead of business days? Commenters should explain their answers.

We also request comment on how many broker-dealers making a market in penny stocks currently use, or would be likely to (if the proposed amendments were adopted) use electronic media to comply with the requirements of Rules 15g-2 and 15g-9.

## VI. Revising Schedule 15G

We are also proposing to revise the penny stock disclosure document and the instructions to it set forth in Schedule 15G under the Exchange Act. The penny stock disclosure document was developed in 1991 and 1992 to provide penny stock investors with brief, standardized information identifying certain risks of investing in low-priced securities and explaining the basic concepts associated with the penny stock market.<sup>99</sup> Some of the proposed revisions are designed to reflect the rule amendments discussed above. Other proposed revisions would streamline the document to make it more readable, and update certain contact information. Among other things, we would eliminate specific references to Nasdaq such as "quoted on NASDAQ," "quoted on the NASDAQ system" or to "the NASD's automated

quotation system." In addition, revised Schedule 15G would inform penny stock customers of the procedures (including waiting periods) that would result from any amendments to the penny stock rules for a broker-dealer to effect a transaction in any penny stock for or with the account of one of its customers. The revised document would also state that penny stocks trade on foreign exchanges as well as on facilities of national securities exchanges.

The current document is divided into two parts. The first part of the penny stock disclosure document, entitled "Important Information on Penny Stocks" (the "Summary Document"), sets forth on a single page the items required to be disclosed pursuant to Section 15(g)(2) of the Exchange Act.<sup>100</sup> The first section of the Summary Document, entitled "Penny stocks can be very risky," briefly defines "penny stock" and identifies certain risks of investing in penny stocks. The second section, entitled "Information you should get," describes the penny stock market and terminology important to an understanding of that market. The final section of the Summary Document, entitled "Brokers' duties and customer's rights and remedies," informs customers who have questions or who have been defrauded that they may have rights or remedies under federal and state law, and provides a toll-free telephone number of the NASD and the central number of NASAA for information on the background and disciplinary history of the firms and salespersons with whom they are dealing, as well as the Commission's complaint number. The second part of the current document (the "Explanatory Document") supplements and explains in greater detail the information provided in the Summary Document.

The revised document would simplify and update the Summary Document and replace the Explanatory Document with a hyperlink to (or in the case of a paper document, the Internet address of) the section of the Commission's Web site that provides investors with information regarding microcap securities, including penny stocks. The revised document is designed to be succinct and to catch the attention of readers by highlighting issues that call for investor caution. Moreover, we believe that the revised document would achieve the purposes of Section 15(g)(2) of the Exchange Act more effectively by providing investors with the information in a more

accessible and understandable format.<sup>101</sup>

We are also proposing to revise Schedule 15G to provide instructions regarding how to electronically provide the penny stock disclosure document.<sup>102</sup> Under the proposed amendments, when broker-dealers electronically send their customers a penny stock disclosure document, the e-mail containing the penny stock disclosure document would be required to have as a subject line: "Important Information on Penny Stocks." If the penny stock disclosure document is reproduced in the text of the e-mail, it would need to be clear, easy to read, and where information is required to be printed in bold-face type, underlined, or capitalized, the amended rule would allow issuers to satisfy such requirements by presenting the information in any manner reasonably calculated to draw attention to it.<sup>103</sup> If the penny stock disclosure document is sent electronically using a hyperlink to where the document is located on the Commission's Web site, the e-mail containing the hyperlink would also need to have as a subject line: "Important Information on Penny Stocks." Immediately before the hyperlink, the text of the e-mail would need to reproduce the following statement in clear, easy-to-read type that is reasonably calculated to draw attention to the words: "We are required by the U.S. Securities and Exchange Commission to give you the following disclosure statement: <http://www.sec.gov/investor/Schedule15G.htm>. It explains some of the risks of investing in penny stocks.

<sup>101</sup> See Adopting Release, 57 FR 18017-18 (discussing the penny stock disclosure document).

<sup>102</sup> In addition to the proposed instructions, the use of electronic media to provide the document is subject to applicable legal requirements. As indicated in note 90, above, we express no view regarding how the Electronic Signatures Act affects the federal securities laws other than with respect to the effect of Section 101(a) of the Act on certain requirements under Exchange Act Rules 15g-2 and 15g-9.

<sup>103</sup> Rather than promulgating and enforcing exacting technical requirements about how the penny stock disclosure document must be presented electronically, we have decided to follow the approach we adopted in 1996. See Exchange Act Rel. No. 37183 (May 9, 1996), 61 FR 24652 (May 15, 1996) ("As proposed, Commission rules that prescribe the physical appearance of a paper document, such as type size and font requirements, are being amended to provide that the issuer, when delivering an electronic version of a document, may comply with the requirements by presenting the information in a format readily communicated to investors. Where legends are required to be printed in red ink or bold-face type, or in a different font size, the amended rules will allow issuers to satisfy such requirements by presenting the legends in any manner reasonably calculated to draw attention to them.").

<sup>98</sup> See, e.g., Rule Concerning Cooling-Off Period for Sales Made at Homes or at Certain Other Locations, 16 CFR 429 (The Federal Trade Commission's cooling-off rule gives a consumer three days to cancel purchases of \$25 or more if the consumer buys an item at home or at a location that is not the seller's permanent place of business).

<sup>99</sup> Proposing Release, 56 FR at 19180.

<sup>100</sup> 15 U.S.C. 78o(g)(2).

Please read it carefully before you agree to purchase or sell a penny stock.”

All e-mail messages transmitting the penny stock disclosure document or a hyperlink to the penny stock disclosure document found on the Commission's Web site would be required to provide the name, address, e-mail address and telephone number of the broker sending the message. Under the proposal, no other information could be included in this e-mail message, except any privacy or confidentiality information routinely included in e-mail messages sent to customers from that broker, as well as instructions on how to provide a signed and dated acknowledgement of receipt of the document.

We would also update the penny stock disclosure document to add the Internet addresses for the Commission, the NASD, Inc. (“NASD”), and the North American Securities Administrators Association (“NASAA”). We would also revise the document to reduce repetition, make it easier to read, and make it more understandable to investors. The current penny stock disclosure document was written over a decade ago and reflects the market as it existed at that time. The proposed revisions to the penny stock disclosure document would bring it up to date, and make it more streamlined and understandable to investors. In particular, much of the detail in the document would be eliminated and replaced with a hyperlink to (or in the case of a paper document, the Internet address of) the section of the Commission's Web site that provides investors with information regarding microcap securities, including penny stocks. We believe that providing a hyperlink (or Internet address) would be an efficient method of alerting potential penny stock investors to the existence of the Commission's Web site and the useful information about investing in such securities that is posted on it. This approach would permit investors to better analyze the penny stock transaction being offered to them since they would have access not only to the portion of the Commission's Web site that deals with investing in penny stocks and microcap securities but to all of the other information posted on the Commission's Web site. An interested investor could, therefore, browse the entire Commission's Web site and, we hope, better educate him or herself before making an investment decision. If a customer requests, a broker-dealer would be required to provide him or her with a copy of the additional information regarding microcap securities, including penny stocks, from the Commission's Web site.

We request comment regarding all of the proposed changes to the penny stock disclosure document. Commenters are encouraged to discuss not only the substance of the document, but also the presentation. For example, we request comment about using a hyperlink (or an Internet address) to inform potential penny stock investors about the risks inherent in investing in penny stocks and microcap securities. Would investors be more or less likely to read such information in a hyperlink than if this information was presented to them at the same time as the penny stock disclosure document? Please explain any comment. We also solicit comment regarding our proposal to permit broker-dealers electronically transmitting the penny stock disclosure document to present the information in the document that is required to be printed in bold-face type, underlined or capitalized in any manner reasonably calculated to draw attention to this information. Should we be more prescriptive and specify in detail how this document should appear electronically? Should the same approach be followed with regard to the required text when a hyperlink to the document on the Commission's Web site is sent to the customer? Moreover, if the penny stock disclosure document is provided to a customer in paper form, should the penny stock broker-dealer be required to provide additional information upon the customer's request? For example, should the penny stock broker-dealer be required to provide a printed version of the section of the Commission's Web site that provides investors with information regarding microcap securities, including penny stocks, or should it be required to provide a modified version of the current Explanatory Document? If the additional information is provided some time after the penny stock disclosure document, should the broker-dealer be required to provide such information before it effects a transaction in that customer's account? Should the two-business-day waiting period begin to run after the customer has received this additional information from the broker-dealer?

## VII. General Request for Comments

In addition to the specific requests for comment above, we are soliciting comments on all aspects of the proposed amendments. Commenters should explain their view in as much detail as appropriate.

## VIII. Paperwork Reduction Act Analysis

### A. Rule 3a51-1 Analysis

The proposed amendments to Rule 3a51-1 do not impose any “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>104</sup> Similarly, the proposed amendments to Rule 15g-100 do not impose any “collection of information” requirements with the meaning of the PRA. Accordingly, the PRA does not apply to these proposed amendments.

### B. Rule 15g-2 and Rule 15g-9 Analyses

Certain provisions of the proposed amendments to Rules 15g-2 and 15g-9 contain “collection of information” requirements within the meaning of the PRA. The Commission has submitted the proposed rule amendments to the Office of Management and Budget (“OMB”) for review in accordance with PRA requirements. An agency may not sponsor, conduct, or require response to an information collection unless a currently valid OMB control number is displayed.

The Commission is proposing to amend the collections of information currently required under Rules 15g-2 and 15g-9 under the Exchange Act. The title for the collection of information under current Rule 15g-2, “Penny Stock Disclosure Rules,” which the Commission is proposing to amend, contains a currently approved collection of information under OMB control number 3235-0434. The title for the collection of information under current Rule 15g-9, “Sales Practice Requirements for Certain Low-Priced Securities,” which the Commission is proposing to amend, contains a currently approved collection of information under OMB control number 3235-0385. The information received by a broker-dealer pursuant to Rules 15g-2 and 15g-9 is mandatory, and is otherwise governed by Regulation S-P<sup>105</sup> and the internal policies of the broker-dealer regarding confidentiality. In addition, the Commission or a self-regulatory organization (“SRO”) may review the information during the course of an examination.

<sup>104</sup> 44 U.S.C. 3501, *et seq.*

<sup>105</sup> See Title V of the Gramm-Leach-Bliley Act, Pub. L. 106-102, 106th Cong., 1st Sess. (codified at 15 U.S.C. 6801 *et seq.* (the “Act”). Pursuant to Section 504 of the Act, the Commission adopted Regulation S-P on June 22, 2000. See 17 CFR Part 248, Privacy of Consumer Financial Information (Regulation S-P), Exchange Act Rel. No. 42974 (June 22, 2000), 65 FR 40334 (June 29, 2000).

### 1. Summary of Collection of Information

Current Rule 15g-2 requires broker-dealers to provide their customers with a penny stock disclosure document, as set forth in Schedule 15G under the Exchange Act, prior to each customer's first non-exempt transaction in a penny stock. The rule also requires a broker-dealer to obtain from its customer in tangible form a signed acknowledgement that he or she has received the required penny stock disclosure document. The broker-dealer must maintain a copy of the customer's acknowledgement for at least three years following the date on which the penny stock disclosure document was provided to the customer. During the first two years of this period, the document must be maintained in an accessible place.

The substance of the collection of information required by Rule 15g-2 would not change under the proposed amendments. The penny stock disclosure document would still have to be provided by a broker-dealer to a customer prior to a non-exempt transaction in a penny stock, and a signed copy of that document would still have to be received by the broker-dealer and maintained in its records for the required period of time. The means of sending and receiving those documents may change from paper copies to electronic versions of those documents or vice versa.

Current Rule 15g-9 requires a broker-dealer to produce a suitability determination for its customers and to obtain from the customer in tangible form a signed copy of that document prior to executing certain recommended transactions in penny stocks. The broker-dealer must also obtain, in tangible form, the customer's agreement to a particular recommended transaction in penny stocks, listing the issuer and number of shares of the particular penny stock to be purchased.

Similarly, the substance of the collection of information required by Rule 15g-9 would not change under the proposed amendments. The suitability determination would still have to be provided by a broker-dealer to a customer and a signed copy of that document would still have to be received by the broker-dealer prior to its effecting a non-exempt transaction in penny stocks for that customer. The only potential change would be the media through which these documents may be sent and received.

As discussed above, the proposed rule amendments respond to advances in technology and legislative developments governing expanded use

of electronic communications. They are intended to maintain investor protections regardless of whether broker-dealers subject to the penny stock rules use paper copies or electronic communications to obtain the required documents and signatures under the Rules.

### 2. Proposed Use of the Information

As discussed in more detail above, Rules 15g-2 and 15g-9 were adopted to provide important protections to investors solicited by broker-dealers to purchase penny stocks. These rules were intended to address some of the abusive and fraudulent sales practices (e.g., boiler room tactics and "pump and dump" schemes) that had characterized the market for penny stocks. The requirement in Rule 15g-2 that a broker-dealer provide the Schedule 15G penny stock disclosure document to its customer prior to effecting a penny stock transaction recommended by the broker-dealer was intended to make the customer aware of the risky nature of investing in penny stocks and provide information about the customer's rights and remedies under the federal securities laws. The requirement in Rule 15g-2 that a broker-dealer obtain in tangible form a signed acknowledgement of receipt of the Schedule 15G penny stock disclosure document was designed to give customers the opportunity to carefully consider, outside of a high-pressure sales call, whether an investment in a penny stock that is recommended by a broker-dealer is appropriate for them.

Similarly, the requirement in Rule 15g-9 that a broker-dealer provide a copy of its suitability determination to the customer prior to the customer's commitment to purchase a penny stock was intended to provide the customer with the opportunity to review that determination and decide whether the broker-dealer has made a good faith attempt to consider the customer's financial situation, investment experience, and investment objectives. The requirement that a broker-dealer receive in tangible form a signed copy of the suitability statement is also intended to convey to the customer the importance of the suitability statement, and to prevent a salesperson from convincing the customer to sign the statement without a review for accuracy. The Rule 15g-9 requirement that the customer provide in tangible form an agreement to a particular transaction is intended to protect investors from fraudulent sales practices by identifying the particular stock and number of shares the customer has agreed to purchase.

The proposed amendments would apply to the means for the collection of information when broker-dealers send and receive the required documents electronically. The waiting period is designed to provide persons communicating electronically with their broker-dealers with protections that are comparable to those under the current rules.

The information collected and maintained by broker-dealers pursuant to Rules 15g-2 and 15g-9, including documents obtained in electronic form pursuant to the proposed rule amendments, may be reviewed during the course of an examination by the Commission or an SRO for compliance with the provisions of the federal securities laws and applicable SRO rules.

### 3. Respondents

Rule 15g-2 only applies to broker-dealers effecting transactions in penny stocks that are not otherwise exempt. It does not apply if the security involved is not a penny stock, or if the broker-dealer did not recommend the transaction to its customer.<sup>106</sup> It also does not apply to a broker-dealer that has not been a market maker in the particular penny stock that it is recommending during the immediately preceding twelve months or has not received more than five percent of its commissions and certain other revenue from transactions in penny stocks during each of the preceding three months.<sup>107</sup> Similarly, transactions with institutional accredited investors are not subject to the rule.<sup>108</sup> The rule also does not apply to transactions that meet the requirements of Regulation D or transactions with an issuer not involving a public offering.<sup>109</sup> A broker-dealer must provide the penny stock disclosure document to its customer only once, prior to the first penny stock transaction that is subject to the rule for that customer. Essentially, then, Rule 15g-2 only applies to broker-dealers making markets in the penny stocks they are recommending to non-accredited investors when they enter into their first penny stock transactions.

<sup>106</sup> Rule 15g-1(e) [17 CFR 240.15g-1(e)].

<sup>107</sup> Rule 15g-1(a) [17 CFR 240.15g-1(a)].

<sup>108</sup> See Rule 15g-1(b) [17 CFR 240.15g-1(b)].

<sup>109</sup> See Rule 15g-1(c) [17 CFR 240.15g-1(c)]. It also does not apply to transactions in which the customer is an issuer, or a director, officer, general partner, or direct or indirect beneficial owner of more than 5% of any class or equity security of the issuer of the penny stock that is the subject of the transaction. Rule 15g-1(d) [17 CFR 240.15g-1(d)].

The same exemptions apply to Rule 15g-9 as Rule 15g-2,<sup>110</sup> along with one additional exemption. The provisions of Rule 15g-9 do not apply if the customer is an "established customer" of the broker-dealer; that is, if the customer has had an account with the broker-dealer in which the customer (i) has effected a securities transaction or deposited funds more than one year previously, or (ii) has already made three purchases involving different penny stocks on different days.<sup>111</sup> Thus, the requirements to provide a suitability determination and a transaction agreement under Rule 15g-9 only apply in limited circumstances—if the customer is a relatively new customer of the penny stock market-making broker-dealer or has limited experience with penny stocks and is not an institutional accredited investor, and if the broker-dealer has solicited the customer to engage in a penny stock transaction. While a broker-dealer must provide the suitability determination to its customer once prior to that customer's first penny stock transaction that is subject to the rule, the broker-dealer may have to obtain more than a single transaction agreement under the rule, depending on the circumstances. The Commission estimates there are approximately 240 broker-dealers making markets in penny stocks that could, potentially, be subject to either Rule 15g-2 or Rule 15g-9.<sup>112</sup>

<sup>110</sup> Rule 15g-9(c) [17 CFR 240.15g-9(c)] provides that transactions exempt under Rules 15g-1(a) (non-market maker exemption), 15g-1(b) (institutional accredited investor exemption), 15g-1(d) (issuer/officer/director/significant shareholder exemption), and 15g-1(e) (non-recommended transaction exemption) are not subject to the rule. While Rule 15g-9 does not specifically include the exemption found in Rule 15g-1(c), it nevertheless provides a somewhat similar exemption in that it exempts transactions that meet the requirements of 17 CFR 230.505 or 230.506 (including, where applicable, the requirements of 17 CFR 230.501 through 230.506, and 17 CFR 230.507 through 230.508), or transactions with an issuer not involving a public offering.

<sup>111</sup> See Rules 15g-9(c)(3) and 15g-9(d)(2) [17 CFR 240.15g-9(c)(3) and 240.15g-9(c)(4)].

<sup>112</sup> The Commission estimates that there are approximately 120 penny stock dealers potentially subject to the penny stock rules. Since the identities of penny stock dealers are not readily available, the staff of the Commission developed a methodology to identify them. The staff estimates that there might be as few as 60 penny stock dealers, or as many as 240, potentially subject to the penny stock rules. We have used the upper bound of this range as a conservative estimate in order to decrease the likelihood that we understate the potential costs of these amendments. The staff identified penny stock dealers based on the ratio of their transaction activity in penny stocks to their trading in all stocks. Penny stocks were identified using company financial statements and information on stock prices.

#### 4. Total Annual Reporting and Recordkeeping Burden

The proposed amendments are intended to adapt Rules 15g-2 and 15g-9 to an electronic or Internet-based environment. Under the proposed amendments, all penny stock transactions that are not exempted would be subject to a waiting period of two business days from the time a broker-dealer sends the required documents to its penny stock customer. As discussed above, the current rules were designed to effectively provide a similar waiting period through the imposition of the obligation to obtain signatures and agreements in tangible form. Therefore, except for the imposition of a formal waiting period, the proposed rule amendments would not impose any significant additional recordkeeping, reporting or other compliance requirement on broker-dealers.

Under the proposed amendments, a broker-dealer that becomes subject to the waiting period by complying with the current rules' requirements through electronic communications may incur some additional costs associated with keeping track of the waiting period. Hence, under the proposed amendments, broker-dealers subject to the penny stock rules may need to develop a tracking method to ensure compliance with the waiting period after receipt of the required signatures and agreements under the rules. We would not expect this to result in more than a minimal increase in burden. Moreover, there should be no non-hour costs associated with the requirement.

It should be noted, however, that only the transaction agreement required under Rule 15g-9(a)(2)(ii) is required for a particular transaction. Neither the suitability determination required under Rule 15g-9(b) nor the penny stock disclosure document required to be given to a customer under Rule 15g-2 is transaction-specific. Rather these documents may be provided to the customer at any time prior to the broker-dealer effecting a recommended penny stock transaction for the customer.

#### a. Estimated Burden Hours

##### i. Burden Hours for Rule 15g-2

The Commission estimates that there are approximately 240 broker-dealers potentially subject to current Rule 15g-2, and the Commission has previously estimated that each one of these firms processes an average of three new customers for penny stocks per week. Thus, each respondent would process approximately 156 penny stock disclosure documents per year. Under

current Rule 15g-2, the Commission calculated that (a) the copying and mailing of the penny stock disclosure document should take no more than two minutes per customer, and (b) each customer should take no more than eight minutes to review, sign and return the penny stock disclosure document. Thus, the total existing respondent burden is approximately 10 minutes per response, or an aggregate total of 1,560 minutes per respondent. Since there are 240 respondents, the current annual burden is 374,400 minutes (1,560 minutes per each of the 240 respondents) or 6,240 hours. In addition, broker-dealers could incur a recordkeeping burden of approximately two minutes per response. Since there are approximately 156 responses for each respondent, the respondents would incur an aggregate recordkeeping burden of 74,880 minutes (240 respondents  $\times$  156 responses for each  $\times$  2 minutes per response), or, 1,248 hours, under current Rule 15g-2. Accordingly, the aggregate annual hour burden associated with current Rule 15g-2 (that is, if all respondents continue to provide paper copies and obtain paper-based signatures) is approximately 7,488 hours (6,240 response hours + 1,248 recordkeeping hours).

Under the proposed amendments, the burden hours associated with Rule 15g-2 may be slightly reduced where the penny stock disclosure document required under the rule is provided through electronic means such as e-mail from the broker-dealer (e.g., the broker-dealer respondent may take only one minute instead of the two estimated above to provide the penny stock disclosure document by e-mail rather than regular mail to its customer) and return e-mail from the customer (the customer may take only seven minutes, to review, electronically sign and electronically return the disclosure document). In this regard, if each of the customer respondents estimated above communicates with his or her broker-dealer electronically, the total ongoing respondent burden would be approximately 8 minutes per response, or an aggregate total of 1,248 minutes (156 new customers  $\times$  8 minutes per respondent). Since there are 240 respondents, the annual burden would be, if electronic communications were used by all customers, 299,520 minutes (1,248 minutes per each of the 240 respondents), or, 4,992 hours. Based on information currently before us, we do not believe that recordkeeping burdens under Rule 15g-2 would increase where the required documents are sent or

received through means of electronic communication, so the recordkeeping burden would remain at 1,248 hours. Thus, if all broker-dealer respondents would obtain and send the documents required under the rules electronically, the aggregate annual hour burden associated with Rule 15g-2 would be 6,240 (1,248 hours + 4,992 hours).

In addition, if the penny stock customer requests a paper copy of the information on the Commission's Web site regarding microcap securities, including penny stocks, we estimate that the printing and mailing of the document containing this information should take no more than two minutes per customer. Because many investors will have access to the Commission's Web site via computers located in their homes or in easily accessible public places such as libraries, we estimate that at most a quarter of investors to whom Rule 15g-2 would apply will request their broker or dealer to provide them with the additional microcap and penny stock information posted on the Commission's Web site. Thus, each respondent would process approximately 39 requests for paper copies of this information per year or an aggregate total of 78 minutes per respondent (2 minutes per customer  $\times$  39 requests per respondent). Since there are 240 respondents, the estimated annual burden is 18,720 minutes (78 minutes per each of the 240 respondents) or 312 hours.

We have no way of knowing how many broker-dealers and customers would choose to communicate electronically. If we assume, however, that 50% of respondents would continue to provide documents and obtain signatures in tangible form and 50% would choose to communicate electronically in satisfaction of the requirements of Rule 15g-2, the total aggregate burden hours would be 7,176 (aggregate burden hours for documents and signatures in tangible form  $\times$  0.50 of the respondents = 3,744 hours) + (aggregate burden hours for electronically signed and transmitted documents  $\times$  0.50 of the respondents = 3,120 hours) + (312 burden hours for those customers making requests for a copy of the information on the Commission's Web site)).

#### ii. Burden Hours for Rule 15g-9

Likewise, there are approximately 240 broker-dealers potentially subject to current Rule 15g-9.<sup>113</sup> Although the burden of the rule on a respondent varies depending on the frequency with which new customers are solicited, the

Commission previously estimated that firms process an average of three new customers for penny stocks per week. Thus, each respondent would process approximately 156 new customer suitability determinations per year. The Commission estimates that a broker-dealer would expend approximately one-half hour per new customer in obtaining, reviewing, and processing (including mailing to the customer) the information required by the Rule, and each respondent would consequently spend 78 hours annually (156 customers  $\times$  .5 hours) obtaining the information required in the Rule. Since there are 240 broker-dealer respondents, the current annual burden is 18,720 hours (240 respondents  $\times$  78 hours).

In addition, as with Rule 15g-2, each customer should take (i) no more than eight minutes to review, sign and return the suitability determination document; and (ii) no more than two minutes to either read and return or produce the customer agreement to a particular recommended transaction in penny stocks, listing the issuer and number of shares of the particular penny stock to be purchased, and send it to the broker-dealer. Thus, the total current customer respondent burden is approximately 10 minutes per response, for an aggregate total of 1,560 minutes for each broker-dealer respondent. Since there are 240 respondents, the current annual burden for customer responses is 374,400 minutes (1,560 customer minutes per each of the 240 respondents), or 6,240 hours.

In addition, broker-dealers incur a recordkeeping burden under Rule 15g-9 of approximately two minutes per response. Since there are 240 broker-dealer respondents and each respondent would have approximately 156 responses annually, respondents would incur an aggregate recordkeeping burden of 74,880 minutes (240 respondents  $\times$  156 responses  $\times$  2 minutes per response), or 1,248 hours.

Accordingly, the current aggregate annual hour burden associated with Rule 15g-9 is 26,208 hours (18,720 hours to prepare the suitability statement and agreement + 6,240 hours for customer review + 1,248 recordkeeping hours).

Under the proposed amendments, the burden hours under amended Rule 15g-9 may be slightly reduced if the transaction agreement required under the rule is provided through electronic means such as e-mail from the customer to the broker-dealer (e.g., the customer may take only one minute instead of the two estimated above to provide the transaction agreement by e-mail rather than regular mail). If each of the

customer respondents estimated above communicates with his or her broker-dealer electronically, the total burden hours on the customers would be reduced from 10 minutes to 9 minutes per response, or an aggregate total of 1,404 minutes per respondent (156 customers  $\times$  9 minutes for each customer). Since there are 240 respondents, the annual customer respondent burden, if electronic communications were used by all customers, would be approximately 336,960 minutes (240 respondents  $\times$  1,404 minutes per each respondent), or 5,616 hours. We do not believe the hour burden on broker-dealers in obtaining, reviewing and processing the suitability determination would be changed through use of electronic communications. In addition, we do not believe, based on information currently available to us that recordkeeping burdens under Rule 15g-9 would change where the required documents were sent or received through means of electronic communication. Thus, if all broker-dealer respondents obtain and send the documents required under the Rule electronically, the aggregate annual hour burden associated with Rule 15g-9 would be 25,584 hours (18,720 hours to prepare the suitability statement and agreement + 5,616 hours for customer review + 1,248 recordkeeping hours).

We cannot estimate how many broker-dealers and customers would choose to communicate electronically. If we assume, however, that 50% of respondents would continue to provide documents and obtain signatures in tangible form and 50% would choose to communicate electronically in satisfaction of the requirements of Rule 15g-9, the total aggregate hour burden would be 25,896 burden hours ((26,208 aggregate burden hours for documents and signatures in tangible form  $\times$  0.50 of the respondents = 13,104 hours) + (25,584 aggregate burden hours for electronically signed and transmitted documents  $\times$  0.50 of the respondents = 12,792 hours)).

#### iii. Aggregate Burden Hours for the Proposed Rule Amendments

Under the proposed amendments the burden hours required for compliance with Rule 15g-2, in light of the potential use of electronic communications would be an estimated 7,176 burden hours. The burden hours required for compliance with Rule 15g-9, in light of the option of using electronic means of communications would be an estimated 25,896 hours. Thus, under the proposed amendments, the total aggregate burden hours for complying with the requirements of Rules 15g-2 and 15g-9,

<sup>113</sup> See note 112, above.



in light of the available means of communication would be 33,072 hours (7,176 hours + 25,896 hours).

## **b. Estimate of Total Annualized Paperwork Cost Burden**

### **i. Cost Burden of Rule 15g-2**

The paperwork costs of complying with the signature and document requirements of current Rule 15g-2 in tangible form entail the costs of mailing the Schedule 15G disclosure document to the customer and providing a means to return the signed document (such as by return postage pre-paid envelopes). Postage costs (at \$0.37 each, \$0.74 for both the outgoing and prepaid incoming documents) related to providing the Schedule 15G and receiving the signed copy from the customer as required by the rule would be approximately \$27,706 (240 respondents × 156 new customers annually × \$0.74 for each document). The staff time required to send the document to a customer is estimated at an average compensation rate of \$24.10/hour.<sup>114</sup> A broker-dealer's copying, sending and recordkeeping hour burden under the current rule, as noted above, is 4 minutes ( $\frac{1}{15}$  of an hour). Staff time would therefore cost approximately \$1.61 for each Schedule 15G provided to a customer under the rule. The total paperwork cost burden for staff time to comply with current Rule 15g-2 would be approximately \$60,278 (240 respondents × 156 new customers annually × \$1.61 for each document). Thus, the total paperwork annual cost burden to the industry to comply with current Rule 15g-2 is approximately \$87,984 (\$27,706 for postage × \$60,278 for staff time).

Electronic communication of the Schedule 15G document would reduce the costs of compliance with Rule 15g-2. There would be no postage costs for electronically transmitted documents, and staff time for e-mailing the disclosure document to the customer may be reduced (e.g., the broker-dealer respondent may take only 1 minute instead of the two estimated burden minutes to provide the penny stock disclosure document by e-mail rather than regular mail to its customer). Recordkeeping costs would likely remain the same. If all of the respondents estimated above send the

Schedule 15G electronically, the total ongoing burden on broker-dealers would decrease from four minutes to three minutes per document disseminated, for an aggregate total of 112,320 minutes (240 respondents × 156 responses × 3 minutes for each response), or 1,872 hours. At a staff time rate of \$24.10/hour total staff costs for compliance with the rule if all communication is electronic would be \$45,115 (1,872 hours × \$24.10/hour). Thus, if *all* broker-dealer respondents would obtain and send the documents required under the rules electronically, the total annual paperwork cost burden to the industry to comply with Rule 15g-2 would be approximately \$45,115 (\$0.00 postage + \$45,115 staff time).

Moreover, the broker or dealer would incur additional postage costs under the proposed amendments when a customer requested a paper copy of the information found on the Commission's Web site regarding microcap securities, including penny stocks. As discussed above, we believe that such a request would be made at most in only a quarter of these transactions. Because there will be no return postage, each such request would result in a postage cost to the broker or dealer of \$0.37. Thus, the aggregate annual postage cost for mailing documents containing the additional information will be \$3,463 (240 respondents × 39 new customers annually × \$0.37).

We cannot estimate how many broker-dealers and customers would choose to communicate electronically. If we assume, however, that 50% of respondents would continue to provide documents and obtain signatures in tangible form and 50% would choose to communicate electronically in satisfaction of the requirements of Rule 15g-2, the total aggregate cost burden to the industry to comply with amended Rule 15g-2 would be approximately \$70,013 ((\$87,984 aggregate cost for documents and signatures in tangible form under the current rule × 0.50 of the respondents = \$43,992) + (\$45,115 aggregate cost burden for electronically signed and transmitted documents × 0.50 of the respondents = \$22,558) + (\$3,463 in postage for customers requesting tangible copies of the additional information on microcap and penny stocks on the Commission's Web site)).

### **ii. Cost Burden of Rule 15g-9**

The Commission believes that, generally, a registered representative of a registered broker-dealer obtains the information required by current Rule 15g-9 and makes the suitability determination. The branch operations

manager of the firm and the compliance officer reviews the information before it is mailed to the customer. The Commission has estimated that the average blended cost to the firm for these personnel is \$75 per hour,<sup>115</sup> and the annualized cost for compliance with this portion of the current Rule is \$1,404,000 (18,720 hours × \$75/hour personnel costs).

In addition to the costs of preparing the suitability determination under the rule, broker-dealers also incur the cost of delivering that suitability statement to their customers, and of receiving both the signed acknowledgement of receiving the statement from the customers as well as the transaction agreement required by the rule (such as by return postage pre-paid envelopes). Postage costs (at \$0.37 each, \$0.74 for both the outgoing and prepaid incoming documents) related to providing the suitability statement and receiving the signed copy from the customer and the transaction agreement is approximately \$27,706 (240 respondents × 156 new customers annually × \$0.74 for each document).

In addition, broker-dealers incur a recordkeeping burden under current Rule 15g-9 of approximately two minutes per response. As noted above, the aggregate recordkeeping burden for compliance with current Rule 15g-9 is 1,248 hours. Using a \$24.10/hour average for recordkeeping staff time, the aggregate annual recordkeeping cost burden associated with Rule 15g-9 is \$30,077 (1,248 hours × \$24.10/hour staff costs). Thus, the total aggregate annual cost burden to broker-dealers under current Rule 15g-9 is approximately \$1,461,783 (\$1,404,000 staff costs to prepare and send the suitability statement and agreement + \$27,706 postage + \$30,077 recordkeeping personnel costs).

The cost burden under Rule 15g-9 may be reduced where the suitability statement and transaction agreement required under the rule are communicated between the broker-dealer and the customer through electronic means. If each of the customer respondents estimated above communicates with his or her broker-dealer electronically, the costs of

<sup>114</sup> A compliance clerk working in New York makes \$26.33 an hour. A compliance clerk working outside New York makes \$21.88 an hour. The average hourly salary of these two positions is \$24.10 an hour. See *Report on Office Salaries in the Securities Industry 2002*, published by the Securities Industry Association. The same rate is being used below to estimate recordkeeping staff costs for compliance with Rule 15g-9.

<sup>115</sup> Branch Operations Managers in New York City make \$99.60 an hour, including overhead. Compliance managers working in New York City make \$111.75 an hour, including overhead. A senior branch operations supervisor outside of New York City makes \$37.05 an hour, including overhead. While a compliance manager outside New York City makes \$52/hour, including overhead. Hence, the blended rate of these four positions is approximately \$75 an hour. See *Report On Management & Professional Earnings In The Securities Industry 2002*.

postage for delivery of the required documents would be \$0.00. We do not believe that the personnel cost burden on broker-dealers and their personnel in obtaining, reviewing and processing the suitability determination would change through use of electronic communications. In addition, we do not believe, based on the information currently available, that recordkeeping burdens under Rule 15g-9 would change where the required documents were sent or received through means of electronic communication. Thus, if *all* broker-dealer respondents were to obtain and send the documents required under Rule 15g-9 electronically, the aggregate annual cost burden associated with Rule 15g-9 would be approximately \$1,434,077 (\$14,040,000 staff costs relating to the suitability statement and agreement + \$0.00 postage costs + \$30,077 recordkeeping personnel costs).

We cannot estimate how many broker-dealers and customers would choose to communicate electronically. If we assume, however, that 50% of respondents would continue to provide documents and obtain signatures in tangible form and 50% would choose to communicate electronically in satisfaction of the requirements of Rule 15g-9, the total aggregate paperwork cost burden to the industry to comply with amended Rule 15g-9 would be approximately \$1,447,930 (((\$1,461,783 aggregate cost burden for documents and signatures in tangible form  $\times$  0.50 of the respondents = \$730,891) + (\$1,434,077 aggregate cost burden for electronically signed and transmitted documents  $\times$  0.50 of the respondents = \$717,039)).

### iii. Aggregate Paperwork Cost Burden for the Proposed Rule Amendments to 15g-2 and 15g-9

As noted above, the annual paperwork cost burden required for compliance with amended Rule 15g-2, in light of the available means of communication would be an estimated \$70,013. The annual cost burden required for compliance with amended Rule 15g-9, in light of the available means of communication would be an estimated \$1,447,930. Thus, the estimated total aggregate cost burden for complying with the proposed amendments to Rules 15g-2 and 15g-9, in light of the available means of communication, would be \$1,517,943 (\$70,013 for Rule 15g-2 + \$1,447,930 for Rule 15g-9).

We note that the proposed rule amendments may not significantly alter the current burden on broker-dealers because those broker-dealers must

provide the required documents to their customers and obtain from their customers the requisite documents and signatures regardless of whether they communicate with their customers electronically or by more traditional means.

It should also be noted that, for purposes of the PRA, the annual reporting and recordkeeping cost burden must exclude the cost of hour burden.<sup>116</sup> Therefore, the reported annual cost burden required for compliance with amended Rules 15g-2 and 15g-9 would include only the postage costs detailed above, and would exclude costs for staff. We are assuming that 50% of respondents would use electronic means to comply with the amended rule and 50% of respondents would use traditional means of communication. Hence, the estimated cost burden for compliance with amended Rule 15g-2 would be approximately \$17,316 ((\$27,706 for postage  $\times$  .50 of the respondents) + (3,463 for postage for those customers requesting a tangible copy of the information on the Commission's Web site regarding microcap securities, including penny stocks)), and the estimated cost burden for compliance with amended Rule 15g-9 would also be estimated at \$13,853 (\$27,706 for postage  $\times$  .50 of respondents).

### 5. General Information About the Collection of Information

Any collection of information pursuant to Rules 15g-2 and 15g-9 is mandatory. For all non-exempt transactions in penny stocks, broker-dealers must provide the penny stock disclosure document required under Rule 15g-2 and the suitability determination required under Rule 15g-9 to their customers. Broker-dealers must maintain a copy of the customer's acknowledgement for at least three years following the date on which the penny stock disclosure document and the suitability determination were provided to the customer. During the first two years of this period, these documents must be maintained in an easily accessible place.<sup>117</sup> The information collected and maintained by broker-dealers pursuant to the proposed rule amendments may be reviewed during the course of an examination by the Commission or the SROs for compliance with the provisions of the federal securities laws and applicable SRO rules. The Commission and SROs would

obtain possession of the information only upon request.

### 6. Request for Comment

We request comment in order to: (a) Evaluate whether the proposed information collection is necessary for the proper performance of the functions of the Commission, including whether the information will have practical utility; (b) evaluate the accuracy of our estimate of the burden of the proposed rules; (c) determine whether there are ways to enhance the quality, utility and clarity of the information to be collected; (d) evaluate whether there are ways to minimize the burden of the proposed rules on those who respond, including through the use of automated collection techniques or other forms of information technology; and (e) evaluate whether the proposed amendments would have any effects on any other collection of information not previously identified in this section.<sup>118</sup> We are particularly interested in receiving comment regarding the number of broker-dealers that currently make a market in penny stocks. Moreover, we also request comment on how many of these broker-dealers plan to use electronic media to comply with the requirements of Rules 15g-2 and 15g-9.

Any member of the public may direct to us any comments concerning the accuracy of these burden estimates and any suggestions for reducing the burdens. Persons who desire to submit comments on the proposed collection of information requirement should direct their comments to the OMB, Attention: Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Washington, DC 20503, and send a copy of the comments to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609, with reference to File No. S7-02-04. Requests for materials submitted to the OMB by us with regard to this collection of information should be in writing, refer to File No. S7-02-04 and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549. Because the OMB is required to make a decision concerning the collection of information between 30 and 60 days after publication, your comments are best assured of having their full effect if the OMB receives them within 30 days of publication.

<sup>116</sup> See OMB Form 83-1, Instructions to Item 14.

<sup>117</sup> See Rule 15g-2(b) and Rule 17a-4 [17 CFR 240.17a-4].

<sup>118</sup> Comments are requested pursuant to 44 U.S.C. 3506(c)(2)(B).

## IX. Costs and Benefits of Proposed Rulemaking

The Commission is considering the costs and benefits of the proposed amendments to Rule 3a51-1 and Rules 15g-2, 15g-9 and 15g-100. We are sensitive to the costs and benefits that might arise from compliance with our rules and amendments.

### A. Rule 3a51-1

The Commission believes that the costs of the proposed amendments to the Rule 3a51-1 should be minimal. The changes we are proposing would have only a limited impact on the penny stock market. For example, we are proposing to amend the current exclusions from the definition of penny stock for reported securities and for certain other exchange-registered securities to require that these securities also satisfy one of the following new standards. First, an exchange-registered security could qualify if the exchange on which it is registered has been continuously registered since the Commission initially adopted the penny stock rules and if the exchange has maintained and continues to maintain quantitative listing standards substantially similar to those in place on January 8, 2004. Second, an exchange-registered security or a reported security listed on an automated quotation system sponsored by a registered national securities association such as Nasdaq could qualify if the exchange or the automated quotation system on which it is registered or listed has quantitative listing standards that meet or exceed standards modeled on those currently required for inclusion in the Nasdaq SmallCap Market. These amendments, however, would be wholly prospective, and are not intended to change the status quo. We believe that securities currently listed and traded on national securities exchanges and on Nasdaq would continue to be excluded from the definition of penny stock. Moreover, all national securities exchanges have initial listing and continued listing standards,<sup>119</sup> which have been reviewed and approved by the Commission.<sup>120</sup> Any cost associated with the proposed rule amendments are further mitigated because the listing standards in the amendments have been patterned after those currently used by the Nasdaq SmallCap Market. Thus all securities now traded on Nasdaq, both National Market System securities and Smallcap

Market securities, should meet the proposed new listing standards.

Moreover, we expect the proposed amendments to benefit both the securities markets and the investing public. Investors would benefit because the revised definition of penny stock would better ensure that they receive the extra protection of the penny stock rules when needed. The proposed amendments to the rule would prevent securities that have all the risky characteristics of penny stocks from being excluded from the definition of penny stock. These benefits, however, are difficult to quantify.

The proposed amendments would also reduce duplicative regulation with respect to security futures products and would also enhance legal certainty by deleting outdated and possibly confusing sections of the rule. Given the incremental change to the costs associated with the rule, we believe the benefits of the proposed amendments will justify the costs.

### B. Rules 15g-2 and 15g-9

We do not expect the proposed amendments to Rules 15g-2 and 15g-9 to impose any new regulatory costs on broker-dealers. The proposed amendments merely impose an explicit, rather than implicit, waiting period on broker-dealers prior to their effecting a penny stock transaction for a customer after receipt of a signed acknowledgement of a penny stock disclosure document, or suitability statement or agreement for a penny stock transaction. Because the penny stock rules, as they operate today, essentially impose a waiting period before certain penny stock transactions may be effected when non-electronic methods of transmittal are used, we do not believe that the proposed rule amendments would produce any significant new costs.<sup>121</sup> We have set forth above many of the costs we believe are involved in complying with both the current rules and the proposed rule amendments in our discussion of the Paperwork Reduction Act.

There also may be lost opportunity costs due to the imposition of an explicit two-business-day waiting period for transactions recommended by

a market-making penny stock broker-dealer that communicates electronically with its customers. We believe, however, that the effect of the waiting periods set forth above on investors would be minimal in light of the fact that the scope of the rules is quite narrow. As noted above, the effect of the operation of these proposed rule amendments would strongly resemble the operation of current Rule 15g-2 and 15g-9 with respect to broker-dealers who satisfy their obligations using non-electronic methods. For example, only those transactions recommended by a market-making broker-dealer in penny stocks are subject to the rules. In addition, the requirements of Rule 15g-9 do not apply to recommended transactions with "established customers" as defined in that rule. On the other hand, providing and receiving the required customer protection documents under the rules through electronic means may save penny stock broker-dealers subject to the rules the out-of-pocket costs of postage or other delivery methods.

Failure to adopt rule amendments that address electronic communications could, however, ultimately foster an increase in high-pressure sales tactics by some penny stock dealers through electronic means, leading to potential investor losses. If the market for penny stocks once again becomes characterized by abusive and fraudulent sales practices, investment in the stocks of legitimate penny stock issuers could diminish. We believe that any costs associated with the proposed amendments to the Rules 15g-2 and 15g-9 are justified by the benefits of reducing fraud.<sup>122</sup>

### C. Rule 15g-100

The Commission believes that the costs of the proposed amendments to the penny stock disclosure document set forth in Schedule 15G should be minimal. The changes we are proposing would have only a limited impact on those broker-dealers making markets in penny stocks because of the narrow circumstances in which this document is required. The proposed changes to this document would not effect the frequency with which it is sent to customers. In addition, we believe that these changes would help reduce fraud by making the document more

<sup>121</sup> Practically speaking, broker-dealers in penny stocks today that are subject to current Rules 15g-2 and 15g-9 are essentially required to wait a minimum of 2 days before executing a penny stock transaction they solicited if they use non-electronic methods. As noted above, unless a person walked into a penny stock broker-dealer's offices and executed the required documents on-the-spot, a broker would have to wait at least two business days before executing a penny stock trade for a new customer under current rules using non-electronic methods.

<sup>122</sup> When it adopted Rule 15g-9, the Commission stated that "we continue to believe that any additional costs imposed by the Rule are outweighed by the benefits of reducing fraud through more effective regulation of the sales practices of broker-dealers active in the market for penny stocks." Exchange Act Rel. No. 27160, 54 FR at 35480-81.

<sup>119</sup> See e.g., NASD Rule 4310.

<sup>120</sup> Section 19(b)(1) of the Exchange Act [15 U.S.C. 78s(b)(1)].

accessible and understandable to investors.

We request that commentators address the costs and benefits of the proposed amendments to Rule 3a51-1 and to Rules 15g-2, 15g-9 and 15g-100, and provide supporting empirical data for any positions advanced. Specifically, we seek comment on whether, and to what extent, the proposed rule amendments would impose costs in addition to those already imposed under the current rules.

#### **X. Consideration of Burden on Promotion of Efficiency, Competition, and Capital Formation**

Section 3(f) of the Exchange Act requires the Commission, when engaging in a rulemaking, to consider or determine whether an action is necessary or appropriate in the public interest, to also consider whether the action would promote efficiency, competition and capital formation.<sup>123</sup> Section 23(a)(2) of the Exchange Act requires us to consider the anticompetitive effects of any rules that we adopt under the Exchange Act.<sup>124</sup> Section 23(a)(2) prohibits us from adopting any rules that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. We believe that the proposed amendments to Rules 3a51-1, 15g-2, 15g-9 and 15g-100 are consistent with the public interest and would promote efficiency, competition and capital formation by providing greater protections for investors, thus increasing investor confidence and involvement in the securities of small businesses.<sup>125</sup>

We do not believe that the amendments we are proposing to Rules 3a51-1, 15g-2, 15g-9, and 15g-100 will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. As discussed above, the proposed amendments to Rule 3a51-1 are prospective only and not intended to affect the status quo. Conceivably, however, the proposed amendments might impose some competitive burdens

on wholly new markets or wholly new facilities or "junior tiers" of markets. We believe that such future competitive burdens would be more than justified by the future benefits of the proposed amendments. These amendments to Rule 3a51-1 would prevent securities that have all the risky characteristics of penny stocks from being excluded from the definition of penny stock. As a result, investors buying and purchasing these securities would continue to receive the increased protection that Congress intended they enjoy in Penny Stock Reform Act. Similarly, the proposed amendments to Rule 3a51-1 would also promote capital formation by encouraging investment because of increased investor confidence. Moreover, these proposed rule amendments would apply equally to all broker-dealers making markets in penny stocks.

The other changes being proposed to Rule 3a51-1 would encourage efficiency by updating the definition of penny stock. For example, we are proposing to amend the Rule 3a51-1 to exclude security future products from this definition.

Moreover, we do not believe that the explicit waiting periods imposed under the proposed rule amendments to Rules 15g-2 and 15g-9 would increase the already-existent burdens under the penny stock rules. Indeed, the current rules already effectively impose a similar waiting period on non-electronic efforts to satisfy the rules. As discussed in detail above, we believe that prospective investors in penny stocks should have the opportunity to carefully consider, outside of a high-pressure environment, whether an investment in penny stocks is appropriate for them. The proposed rule amendments would merely ensure that all investors in penny stocks, whether they communicate through traditional means or electronically, would retain the opportunity for careful consideration.

We do not believe that the proposed amendments to Rules 15g-2 and 15g-9 would adversely affect capital formation. As we said when we first adopted the penny stock rules, without these rules, sales practice abuses in the market may lead investors to bypass the penny stock market in favor of other types of securities. By operating to curb sales practice abuses in the markets for penny stocks, the proposed rule amendments should continue to benefit legitimate penny stock issuers and the broker-dealers making markets in those issuers' securities.

In addition, because these rule amendments would only apply to broker-dealers soliciting customers for

recommended transactions in penny stocks in which they make a market (along with the other exceptions to the rules), any potential adverse effect on efficiency, competition, or capital formation should be limited.

Similarly, we do not believe that the waiting period that would be imposed by the proposed amendments to Rules 15g-2 and 15g-9 would result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The proposed rule amendments essentially translate the implicit waiting periods present under operation of the current rules to the electronic communications arena. Therefore, these proposed rule amendments do not impose any additional competitive burdens on penny stock brokers and dealers. We believe the proposed amendments also would promote competition by redesigning this necessary regulatory scheme to permit broker-dealers and customers to take advantage of rapidly evolving technology.

Finally, we believe that the changes we are proposing to the penny stock disclosure document set forth in Schedule 15G [Rule 15g-100] would not impose any burden on competition. On the contrary, we believe that by streamlining the document, making it more readable, and generally adapting it to electronic media, we are promoting efficiency, competition and capital formation.

The Commission requests comments regarding the impact of the proposed amendments to Rules 3a51-1, 15g-2, 15g-9 and 15g-100 on efficiency, competition and capital formation. Likewise, for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,<sup>126</sup> the Commission is interested in receiving information regarding the potential effect of the proposals on the U.S. economy on an annual basis. Commentators are requested to provide empirical data to support their views.

#### **XI. Initial Regulatory Flexibility Analysis**

Section 3(a) of the Regulatory Flexibility Act<sup>127</sup> requires the Commission to undertake an initial regulatory flexibility analysis of the effects of proposed rules and rule amendments on small entities, unless the Commission certifies that the rules and rule amendments, if adopted, would not have a significant economic

<sup>123</sup> 15 U.S.C. 78c(f).

<sup>124</sup> 15 U.S.C. 78w(a)(2).

<sup>125</sup> See Adopting Release, 57 FR at 18007 ("[T]he Commission also recognizes that fraudulent sales practices, which have occurred disproportionately in this market, may themselves hinder economic growth, because they cause the loss of the productive use of investor funds, and discourage further investment by those who have been defrauded. Legitimate small business is thus harmed by the diversion of substantial capital to unscrupulous promoters and broker-dealers. Moreover, the issuers of penny stocks that are fraudulently traded may themselves be victimized by this activity.").

<sup>126</sup> Pub. L. 104-21, Title II, 110 Stat. 857 (1996).

<sup>127</sup> 5 U.S.C. 603(a).

impact on a substantial number of small entities.<sup>128</sup>

The Commission hereby certifies, pursuant to 5 U.S.C. 605(b), that the proposed amendments to Rules 3a51-1, 15g-2, 15g-9 and Rule 15g-100 contained in this release, if adopted, would not have a significant economic impact on a substantial number of small entities. With respect to the proposed changes to Rule 3a51-1, the scope of the penny stock rules is not being expanded. We believe that securities currently excluded from the definition of penny stock because they are listed on a national securities exchange or quoted on Nasdaq would continue to be excluded. Moreover, we are proposing to exclude security futures products from the definition of penny stock. We therefore believe that the proposed amendments to Rule 3a51-1 should not have a significant impact on a substantial number of small entities.

Similarly, the proposed amendments to Rules 15g-2 and 15g-9 should also not have a significant impact on a substantial number of small entities. The two-business-day waiting period being proposed does not significantly alter the status quo. The signatures and agreements in tangible form under the current rules were intended to provide customers with an opportunity to consider, outside of a high-pressure sales situation, the advisability of investing in the risky penny stock market. The practical effect of these requirements, due to the delay inherent in postal communications, was to impose a waiting period between a broker-dealer's first communication with a customer concerning penny stocks and the broker-dealer's ability to execute a penny stock transaction for that customer. The proposed amendments to Rules 15g-2 and 15g-9 simply attempt to preserve the status quo in the wake of Electronic Signatures Act. The proposed amendments are intended to provide customers using electronic media with protections similar to those given all other investors in penny stocks whose transactions are subject to the penny stock rules—the opportunity for careful consideration inherent in investing in penny stocks.

Finally, we believe that the changes we are proposing to the penny stock disclosure document set forth in Schedule 15G [Rule 15g-100] would not have any significant economic impact on a substantial number of small entities because they represent edits that simplify and shorten an existing disclosure document.

We encourage written comments regarding this certification. We solicit comment as to whether the proposed amendments could have an effect that we have not considered. We request that commenters describe the nature of any impact on small entities and provide empirical data to support the extent of the impact.

## XII. Statutory Authority

The Commission is proposing amendments to 240.3a51-1, 240.15g-2, 240.15g-9 and 240.15g-100 of Title 17, Chapter II of the Code of Federal Regulations pursuant to authority set forth in Sections 3(b), 15(c), 15(g) and 23(a) of the Exchange Act [15 U.S.C. 78c(b), 78o(c), 78o(g), and 78w(a)].

## XIII. Text of Proposed Rule Amendments

### List of Subjects in 17 CFR Part 240

Broker-dealers, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, Title 17, Chapter II of the Code of Federal Regulations is proposed to be amended as follows:

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

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

**Authority:** 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

\* \* \* \* \*

2. Section 240.3a51-1 is amended by revising paragraphs (a), (e) and (f) to read as follows:

#### § 240.3a51-1 Definition of “penny stock”.

\* \* \* \* \*

(a) That is a reported security, as defined in 17 CFR 240.11Aa3-1(a) of this chapter, provided that:

(1) The security is registered, or approved for registration upon notice of issuance, on a national securities exchange that has been continuously registered as a national securities exchange since April 20, 1992 (the date of the adoption of Rule 3a51-1 (17 CFR 240.3a51-1) by the Commission); and the national securities exchange has maintained quantitative listing standards that are substantially similar to or stricter than those listing standards that were in place on that exchange on January 8, 2004; or

(2) The security is registered, or approved for registration upon notice of

issuance, on a national securities exchange, or is listed, or approved for listing upon notice of issuance on, an automated quotation system sponsored by a registered national securities association, that:

(i) Has established initial listing standards that meet or exceed the following criteria:

(A) The issuer shall have:

(1) Stockholders' equity of \$5,000,000;

(2) Market value of listed securities of \$50 million for 90 consecutive days prior to applying for the listing (market value means the closing bid price multiplied by the number of securities listed); or

(3) Net income of \$750,000 (excluding extraordinary or non-recurring items) in the most recently completed fiscal year or in two of the last three most recently completed fiscal years;

(B) The issuer shall have an operating history of at least one year or a market value of listed securities of \$50 million (market value means the closing bid price multiplied by the number of securities listed);

(C) The issuer's stock, common or preferred, shall have a minimum bid price of \$4 per share;

(D) In the case of common stock, there shall be at least 300 round lot holders of the security (a round lot holder means a holder of a normal unit of trading);

(E) In the case of common stock, there shall be at least 1,000,000 publicly held shares and such shares shall have a market value of at least \$5 million (market value means the closing bid price multiplied by number of publicly held shares, and shares held directly or indirectly by an officer or director of the issuer and by any person who is the beneficial owner of more than 10 percent of the total shares outstanding are not considered to be publicly held);

(F) In the case of a convertible debt security, there shall be a principal amount outstanding of at least \$10 million;

(G) In the case of rights and warrants, there shall be at least 100,000 issued and the underlying security shall be registered on a national securities exchange or listed on an automated quotation system sponsored by a registered national securities association and shall satisfy the requirements of paragraphs (a) or (e) of this section;

(H) In the case of put warrants (that is, instruments that grant the holder the right to sell to the issuing company a specified number of shares of the company's common stock, at a specified price until a specified period of time), there shall be at least 100,000 issued and the underlying security shall be

<sup>128</sup> 5 U.S.C. 605(b).

registered on an automated quotation system sponsored by a registered national securities exchange or listed on and shall satisfy the requirements of paragraphs (a) or (e) of this section;

(I) In the case of units (that is, two or more securities traded together), all component parts shall be registered on a national securities exchange or listed on an automated quotation system sponsored by a registered national securities association and shall satisfy the requirements of paragraphs (a) or (e) of this section; and

(J) In the case of equity securities (other than common and preferred stock, convertible debt securities, rights and warrants, put warrants, or units), including hybrid products and derivative securities products, the national securities exchange or registered national securities association shall establish quantitative listing standards that are substantially similar to those found in paragraphs (a)(2)(i)(A) through (a)(2)(i)(I); and

(ii) Has established quantitative continued listing standards that are reasonably related to the initial listing standards set forth above in paragraph (a)(2)(i) of this section, and that are consistent with the maintenance of fair and orderly markets.

\* \* \* \* \*

(e) That is registered, or approved for registration upon notice of issuance, on a national securities exchange that makes transaction reports available pursuant to 17 CFR 240.11Aa3-1, provided that:

(1) Price and volume information with respect to transactions in that security is required to be reported on a current and continuing basis and is made available to vendors of market information pursuant to the rules of the national securities exchange;

(2) The security is purchased or sold in a transaction that is effected on or through the facilities of the national securities exchange, or that is part of the distribution of the security; and

(3) The security satisfies the requirements of paragraphs (a)(1) or (a)(2) of this section; *except that* a security that satisfies the requirements of this paragraph (e), but does not otherwise satisfy the requirements of paragraph (a), (b), (c), (d), (f), or (g) of this section, shall be a penny stock for purposes of Section 15(b)(6) of the Act;

(f) That is a security futures product listed on a national securities exchange or an automated quotation system sponsored by a registered national securities association;

\* \* \* \* \*

3. Section 240.15g-2 is revised to read as follows:

The revisions and additions read as follows:

**§ 240.15g-2 Penny stock disclosure document relating to the penny stock market.**

(a) It shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless, prior to effecting such transaction, the broker or dealer has furnished to the customer a document containing the information set forth in Schedule 15G, 17 CFR 240.15g-100, and has obtained from the customer a signed and dated acknowledgement of receipt of the document.

(b) Regardless of the form of acknowledgement used to satisfy the requirements of paragraph (a) of this section, it shall be unlawful for a broker or dealer to effect a transaction in any penny stock for or with the account of a customer less than two business days after the broker or dealer sends such document.

(c) The broker or dealer shall preserve, as part of its records, a copy of the acknowledgement required by paragraph (a) of this section for the period specified in 17 CFR 240.17a-4(b).

(d) Upon request of the customer, the broker or dealer shall furnish the customer with a copy of the information set forth on the Commission's Web site at <http://www.sec.gov/investor/pubs/microcapstock.htm>.

4. Section 240.15g-9 is amended by revising paragraphs (a)(2)(ii) and (b)(4) to read as follows:

**§ 240.15g-9 Sales practice requirements for certain low-priced securities.**

(a) \* \* \*

(2) \* \* \*

(ii)(A) The broker or dealer has received from the person an agreement to the transaction setting forth the identity and quantity of the penny stock to be purchased; and

(B) Regardless of the form of agreement used to satisfy the requirements of paragraph (A) of this section, it shall be unlawful for such broker or dealer to sell a penny stock to, or to effect the purchase of a penny stock by, for or with the account of a customer less than two business days after the broker or dealer sends such agreement.

(b) \* \* \*

(4)(i) Obtain from the person a signed and dated copy of the statement required by paragraph (b)(3) of this section; and

(ii) Regardless of the form of statement used to satisfy the

requirements of paragraph (b)(4)(i) of this section, it shall be unlawful for such broker or dealer to sell a penny stock to, or to effect the purchase of a penny stock by, for or with the account of a customer less than two business days after the broker or dealer sends such statement.

\* \* \* \* \*

5. Section 240.15g-100 is revised to read as follows:

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

**Securities and Exchange Commission, Washington, DC 20549**

*Schedule 15G*

*Under the Securities Exchange Act of 1934*

*Instructions to Schedule 15G*

A. Schedule 15G (Schedule) may be provided to customers in its entirety either on paper or electronically. It may also be provided to customers electronically through a link to the SEC's Web site.

1. *If the Schedule is sent in paper form*, the format and typeface of the Schedule must be reproduced exactly as presented. For example, words that are capitalized must remain capitalized, and words that are underlined or bold must remain underlined or bold. The typeface must be clear, easy to read, and in 12-point type. The Schedule may be reproduced either by photocopy or by printing.

2. *If the Schedule is sent electronically*, the e-mail containing the Schedule must have as a subject line "Important Information on Penny Stocks." The Schedule reproduced in the text of the e-mail must be clear, easy to read, type presented in a manner reasonably calculated to draw the customer's attention to the language in the document, especially words that are capitalized, underlined or in bold.

3. *If the Schedule is sent electronically using a hyperlink to the SEC Web site*, the e-mail containing the hyperlink must have as a subject line: "Important Information on Penny Stocks." Immediately before the hyperlink, the text of the e-mail must reproduce the following statement in clear, easy-to-read type presented in a manner reasonably calculated to draw the customer's attention to the words: "We are required by the U.S. Securities and Exchange Commission to give you the following disclosure statement: <http://www.sec.gov/investor/Schedule15G.htm>. It explains some of the risks of investing in penny stocks.

Please read it carefully before you agree to purchase or sell a penny stock.”

B. Regardless of how the Schedule is provided to the customer, the communication must also provide the name, address, telephone number and e-mail address of the broker. E-mail messages may also include any privacy or confidentiality information that the broker routinely includes in e-mail messages sent to customers. No other information may be included in these communications, other than instructions on how to provide a signed and dated acknowledgement of receipt of the Schedule.

C. The document entitled “Important Information on Penny Stocks” must be distributed as Schedule 15G and must be no more than two pages in length if provided in paper form.

D. The disclosures made through the Schedule are in addition to any other disclosures that are required under the federal securities laws.

E. Recipients of the document must not be charged any fee for the document.

F. The content of the Schedule is as follows:

[next page]

#### *Important Information on Penny Stocks*

The U.S. Securities and Exchange Commission (SEC) requires your broker to give this statement to you, and to obtain your signature to show that you have received it, before your first trade in a penny stock. This statement contains important information—and you should read it carefully before you sign it, and before you decide to purchase or sell a penny stock.

In addition to obtaining your signature, the SEC requires your broker to wait at least two business days after sending you this statement before executing your first trade to give you time to carefully consider your trade.

#### **Penny Stocks Can Be Very Risky**

Penny stocks are low-priced shares of small companies. Penny stocks may trade infrequently—which means that it may be difficult to sell penny stock shares once you have them. Because it may also be difficult to find quotations for penny stocks, they may be impossible to accurately price. Investors in penny stock should be prepared for the possibility that they may lose their whole investment.

While penny stocks generally trade over-the-counter, they may also trade on U.S. securities exchanges, facilities of U.S. exchanges, or foreign exchanges. You should learn about the market in which the penny stock trades to

determine how much demand there is for this stock and how difficult it will be to sell. Be especially careful if your broker is offering to sell you newly issued penny stock that has no established trading market.

The securities you are considering have not been approved or disapproved by the SEC. Moreover, the SEC has not passed upon the fairness or the merits of this transaction nor upon the accuracy or adequacy of the information contained in any prospectus or any other information provided by an issuer or a broker or dealer.

#### **Information You Should Get**

In addition to this statement, your broker is required to give you a statement of your financial situation and investment goals explaining why his or her firm has determined that penny stocks are a suitable investment for you. In addition, your broker is required to obtain your agreement to the proposed penny stock transaction.

Before you buy penny stock, federal law requires your salesperson to tell you the “offer” and the “bid” on the stock, and the “compensation” the salesperson and the firm receive for the trade. The firm also must send a confirmation of these prices to you after the trade. You will need this price information to determine what profit or loss, if any, you will have when you sell your stock.

The offer price is the wholesale price at which the dealer is willing to sell stock to other dealers. The bid price is the wholesale price at which the dealer is willing to buy the stock from other dealers. In its trade with you, the dealer may add a retail charge to these wholesale prices as compensation (called a “markup” or “markdown”).

The difference between the bid and the offer price is the dealer’s “spread.” A spread that is large compared with the purchase price can make a resale of a stock very costly. To be profitable when you sell, the bid price of your stock must rise above the amount of this spread and the compensation charged by both your selling and purchasing dealers. Remember that if the dealer has no bid price, you may not be able to sell the stock after you buy it, and may lose your whole investment.

After you buy penny stock, your brokerage firm must send you a monthly account statement that gives an estimate of the value of each penny stock in your account, if there is enough information to make an estimate. If the firm has not bought or sold any penny stocks for your account for six months, it can provide these statements every three months.

Additional information about low-priced securities—including penny stocks—is available on the SEC’s Web site at <http://www.sec.gov/investor/pubs/microcapstock.htm>. In addition, your broker will send you a copy of this information upon request. The SEC encourages you to learn all you can before making this investment.

#### **Brokers’ Duties and Customer’s Rights and Remedies**

Remember that your salesperson is not an impartial advisor—he or she is being paid to sell you stock. Do not rely only on the salesperson, but seek outside advice before you buy any stock. You can get the disciplinary history of a salesperson or firm from NASD at 1–800–289–9999 or contact NASD via the Internet at [www.nasdaq.com](http://www.nasdaq.com). You can also get additional information from your state securities official. The North American Securities Administrators Association can give you contact information for your state. You can reach NASAA at (202) 737–0900 or via the Internet at [www.nasaa.org](http://www.nasaa.org).

If you have problems with a salesperson, contact the firm’s compliance officer. You can also contact the securities regulators listed above. Finally, if you are a victim of fraud, you may have rights and remedies under state and federal law. In addition to the regulators listed above, you also may contact the SEC with complaints at (800) SEC–0330 or via the Internet at [help@sec.gov](mailto:help@sec.gov).

\* \* \* \* \*

Dated: January 8, 2004.

By the Commission.

**J. Lynn Taylor,**

*Assistant Secretary.*

[FR Doc. 04–881 Filed 1–15–04; 8:45 am]

BILLING CODE 8010–01–U

## **DEPARTMENT OF HOMELAND SECURITY**

### **Coast Guard**

#### **33 CFR Part 117**

[CGD07–03–166]

RIN 1625–AA09

#### **Drawbridge Operation Regulations; Atlantic Intracoastal Waterway, Miles 1062.6 and 1064.0 in Fort Lauderdale, FL**

**AGENCY:** Coast Guard, DHS.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** The Coast Guard proposes to change the operating regulations of the