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Securities and Exchange Commission
100 F St. NW
Washington, DC 20549-9303
Rule-comments@sec.gov

Re: Publication or Submission of Quotations Without Specified Information a/k/a OTC Disclosure

File S7-14-19

Dear SEC:

The Commission is attempting to combat "pump and dump" microcap fraud by prohibiting broker-dealer quotations for issuers that don't reveal sufficient information. Combatting pump and dump is an important goal. However, the proposal as designed can be improved. Indeed, in its current form it could create a potent tool for downward market manipulation and shareholder expropriation. Here are my comments on the proposed rule change. In summary:

- Regulation Best Interest has superseded the original purpose of 15c2-11.
- The changes as proposed may have some unintended consequences:
    - Reducing transparency and information for "fallen angels."
    - Facilitating shareholder suppression for companies that go dark.

[1] All opinions are strictly my own and do not necessarily represent those of Georgetown University or anyone else.

    - Reducing OTC market making and hence liquidity for small issuers.
- Quoting in formerly exchange-listed companies should be permitted to prevent going-dark manipulations.
- Pure market makers who do not solicit investors should be exempt.
- Companies traded in the OTCQX, OTCQB, and Pink-Current segments of the OTC market should be explicitly exempt without further record keeping or other regulatory burdens on broker dealers.
- The asset test should be based on the public float, not manipulable accounting numbers.
- The draconian Regulation SHO closeout requirements should be replaced with late fees similar to those in the Treasury market.

<u>The current rule is a form of suitability and has been superseded by Regulation Best Interest.</u>

In the words of the proposing release, with ***emphasis*** added:

> "Because broker-dealers play an integral role in facilitating investor access to OTC securities and serve an important gatekeeper function under Rule 15c2-11, it is important that a broker-dealer reviews key, basic information about an issuer ***before initiating a quoted market to solicit retail investors*** to purchase and sell a security in the OTC market."[2]

Note the words "to solicit retail investors." This made good sense back in 1971 when the rule was adopted, as the standard OTC market model at the time was for a broker-dealer-promoter to start quoting a tiny stock and then actively promote the stock to retail investors. The OTC market is very different today, with most of the dollar volume coming from well-known foreign securities along with once-listed "fallen angels" such as Fannie Mae. Furthermore, most of the market making is done by wholesale market makers who are not soliciting retail investors.

The recently promulgated Regulation Best Interest now requires that brokers "have a reasonable basis to believe that the recommendation could be in the best interest of at least some retail customers;"[3] It is quite clear that a broker cannot have a reasonable basis to believe that a recommendation is in the best interest of at least some retail customer without adequate information. Thus, the existing rule has been superseded by Regulation Best Interest and is functionally obsolete for its original purpose of making sure that broker-dealers have adequate information before soliciting retail investors. ***If the Commission were serious about eliminating obsolete and redundant rules, then it should just scrap the rule.***

The rule does, however, have some use to make sure that there is information available to the general public. Indeed, the Commission has long struggled to find ways of insuring adequate financial information to investors in securities that purport to be exempt from existing reporting obligations. This

[2] Proposing release, page 9. https://www.sec.gov/rules/proposed/2019/34-87115.pdf

[3] § 240.15*l*-1 Regulation Best Interest.

rule is a back door means of extracting at least some information from such issuers. If the issuer wants to be quoted, it has to release some information. The proposed rule is thus a blunt tool to force more disclosure from smaller issuers above what is otherwise required from our securities laws.

The benefits of such a regulatory expansion of *de facto* required reporting are a matter of debate, and bring up the philosophical issue of just how much of a nanny regulator the SEC should be. Unlike in 1971 when 15c2-11 was first promulgated, it is now very easy for investors to see whether and how much information a company has disclosed. Should the SEC take away the ability of investors to decide for themselves whether this information is sufficient? Should the SEC restrict or even shut down the entire nano-cap sector in the name of fraud prevention? This would needlessly harm the legitimate firms and their investors in the sector. On the other hand, higher standards in the segment could make it easier to raise capital, but at a higher cost. Should issuers be considered innocent until proven guilty? This is an important judgment call that trades off fraud prevention versus free choice, regulatory burdens, and capital formation for small businesses.

The rule may reduce transparency and liquidity for "fallen angels" and harm innocent investors.

Dealer quotations are an important source of liquidity for investors. It is well known that liquid securities, ceteris paribus, are more valuable than illiquid ones. Anything that causes dealers to refrain from quoting a security will reduce the liquidity, and hence the value, of the security. The Commission in its important efforts to reduce microcap fraud should be very careful not to impose collateral damage on innocent investors.

There are times when the financial statements of legitimate businesses cannot be relied upon. For example, the firm may discover an accounting mistake that will take some time to fix. The existing shareholders should not be penalized by reducing the liquidity of their shares. The classic case is that of Fannie Mae, long before it was placed into conservatorship. Fannie Mae announced that there were accounting irregularities and its financial statements could no longer be relied upon. Nevertheless, its stock was properly allowed to trade on the NYSE during the years it took them to produce audited financial statements.

In statistics, there is a distinction between Type I and Type II errors: A false positive (Type I) versus a false negative (Type II). In its zeal to prevent pump and dumps, the Commission needs to be very careful to make sure that a quoting ban only affects fraudulent companies while limiting collateral damage to legitimate ones and their shareholders.

Pure market makers should be exempt.

As noted above, the existing rule was originally a weak form of suitability: Make sure that at least one broker dealer had information before soliciting retail investors. Regulation Best Interest has superseded this as brokers have to make sure a recommendation is in the best interest of a retail customer.

The largest market makers are not in the business of soliciting retail investors. Instead, they provide liquidity for thousands of securities. As long as they are not in cahoots with the insiders, they should be able to provide liquidity to investors. The rule should thus explicitly exempt market makers who do not solicit retail customers. Other broker-dealers should NOT be permitted to piggyback on market makers making use of the exemption.

Permitting pure market makers who are not soliciting retail customers to quote provides important liquidity to the market and produces important price information. This information is useful to investors as well as a useful tool for enforcement.

The asset test doesn't work if the accounting statements cannot be relied upon. Replace it with a market capitalization test.

The proposed rule attempts to deal with providing quotations to public investors in larger companies through a size exemption of $50 million in assets and $10 million in unaffiliated shareholders' equity. This is all well and good if there are reliable financial statements. But if there are no reliable financial statements, such as when the issuer finds a mistake and states that the financial statements cannot be relied upon, then how would anyone be able to determine that the company meets the size requirement?

The $10 million in unaffiliated shareholders' equity is also problematic because many large legitimate companies can show a negative shareholders' equity. This often occurs with startup ventures with startup losses or after a leveraged recapitalization.

The asset test should be replaced with a market capitalization test based on the public float. If the public float is worth more than $10 million, then the public shareholders should be allowed to have quoting by market makers in their shares. I suggest $10 million as that is what the Commission is suggesting for unaffiliated shareholders' equity. If the accounting value approximates the market value, then the result is the same.

A market capitalization test also has the advantage of simplicity, which will reduce compliance costs for market makers and enforcement costs for regulators.

The proposed rule provides a potent tool for manipulators.

The proposed rule will make it very easy for manipulators to manipulate the price of publicly held securities downward to expropriate value from shareholders. Under the proposed rule, a firm that voluntarily goes dark and intentionally stops providing publicly available financial information can cause quoting in its stock to cease. Such cessation of quotations will make the remaining public shares almost worthless, providing an opportunity for the manipulator to buy the shares on the cheap without the decency of a formal tender offer.

The saga of Equity Inns provides a template for such activity:

Equity Inns was an NYSE-listed REIT that held various hotel properties. The common shares were acquired in a leveraged buyout in 2007, but the NYSE-listed preferred shares were left outstanding. Those in control of the resulting entity, renamed W2007 Grace Acquisition I, then engaged in a scorched earth effort to freeze out the public preferred shareholders. The preferred shares were delisted from the NYSE, and the company filed a Form 15 deregistration statement and the firm went dark.[4]

W2007 Grace Acquisition I provided no publicly available financial information. It would, however, provide existing preferred shareholders some financial information, provided they paid $.10 per page and signed a non-disclosure agreement.[5] The company took the steps needed to make the formerly exchange-listed shares not even DTC-eligible, meaning that shareholders had to revert to using archaic paper stock certificates to transfer shares.

In the midst of the financial crisis, the firm ceased paying the preferred dividends and engaged in a non-publicly disclosed at the time "restructuring" with affiliated insiders that gave the insiders the "option" to purchase the hotels at what appears to be a zero price. With no dividend, no information, and limited transferability, the price of the stock plummeted to the low single digits.

Meanwhile, affiliated insiders were secretly buying up the preferred shares for a pittance. Indeed, their share purchases were more than the total publicly reported shares traded during this period. This shows a serious loophole in required reporting and/or a serious lack of enforcement, as the controlling entities were affiliated with a broker dealer. Despite being informed through proper channels, neither FINRA nor the SEC took any noticeable enforcement action over such blatant violation of the trade reporting rules.

During this time, the number of shareholders of record was high enough to trigger its SEC reporting obligations, which the firm had flagrantly violated.[6] After years of complaints from the aggrieved shareholders, the SEC finally commenced an enforcement action that fined the firm and required it to resume compliance with its reporting obligations.[7]

[4] https://www.sec.gov/Archives/edgar/data/916530/000095014407009932/0000950144-07-009932-index.htm

[5] http://www.snl.com/interactive/lookandfeel/103147/Shareholder.Request.form.pdf

[6] https://www.sec.gov/comments/81-939/81-939.shtml

[7] https://www.sec.gov/litigation/admin/2015/34-74782.pdf

Epilog: As a result of the non-publicly disclosed at the time "restructuring", the preferred shareholders were left with a nearly empty shell. It was only after protracted legal proceedings that the preferred shareholders received anything.[8]

Formerly exchange-listed companies should be explicitly grandfathered.

Manipulators should not be given a tool to shut down the quoting in their stock after it goes dark. There is a simple prevention: Add formerly exchange-listed securities to the list of exemptions. This will prevent expropriators from shutting down quotes of formerly public companies to depress the price so they can buy up the shares on the cheap.

Companies traded in the OTCQX, OTCQB, and Pink-Current segments of the OTC market should be explicitly exempted.

The proposing release attempts to simplify compliance by allowing an IDQS (Interdealer quotation system) to conduct the review needed. This is good, although the obtuse language of the text of the proposed rule can and should be simplified. Indeed, the Commission should explicitly state, either in the adopting release or better yet the text of the adopted rule, that broker dealers may quote securities traded on the OTCQX, OTCQB, and Pink-Current sections of the OTC market without any additional regulatory requirements or record-keeping burdens under this rule.

There is no need or benefit from having broker-dealers redundantly review and retain records of a review for any security traded on the OTCQX, OTCQB, or Pink-Current sections of the OTC market. These market segments already have explicit publicly-available information requirements. Broker-dealers should be able rely on the listing status of such securities without any additional record keeping requirements.

Replace the draconian close out requirements of Regulation 204 with late fees similar to the Treasury market.

The Concept Release asks

> "Would extending the Regulation SHO close-out period for certain market participants enhance price discovery that could result from short selling without also increasing the potential for abusive short selling in this market?"

Regulation 204 has gone a long way to clear up the endemic fails-to-deliver that affected our market prior to 2008. However, the mandatory buy-in procedure has the unintended consequence of facilitating price

[8] https://chimicles.com/w2007-grace-acquisition-i-inc-preferred-shareholder-litigation/

manipulations and short squeezes. The case of Phunware (PHUN) is a classic example. The stock was a Special Purpose Acquisition Corporation (SPAC) that morphed into PHUN. At the time of the transition, the stock spiked from under $10 to over $300 before falling back to the single digits.

Source: finance.yahoo.com

Currently, all market participants are required under Regulation 204 to deliver on the regular settlement date, which is currently T+2.[9] There is a common misconception that market makers are exempt from this. This is not completely accurate. The wording of the rule does not explicitly exempt market makers from the requirement to deliver on the regular settlement date. However, the rule does not require them to be bought in by their clearing firm for three additional settlement days.

However, there are times when a market maker or arbitrageur is legitimately short and a borrow no longer available on any, let alone reasonable, terms. In such situations a relaxation of the settlement requirement is reasonable. For this reason, instead of a mandatory "no matter what" buy in that can lead to absurd price gyrations, those who fail to deliver should be charged a late fee, similar to what is done in the

[9] 17 CFR § 242.204 states "(a) A participant of a registered clearing agency must deliver securities to a registered clearing agency for clearance and settlement on a long or short sale in any equity security by settlement date, or if a participant of a registered clearing agency has a fail to deliver position at a registered clearing agency in any equity security for a long or short sale transaction in that equity security, the participant shall, by no later than the beginning of regular trading hours on the settlement day following the settlement date, immediately close out its fail to deliver position by borrowing or purchasing securities of like kind and quantity;"

Note that this requirement applies to all market participants. 204(a)(3) directs that fails resulting from bona fide market making activities be closed out "no later than the beginning of regular trading hours on the third consecutive settlement day following the settlement date."

Treasury market. The level of the late fee should be high enough to deter market participants from failing instead of borrowing under normal market conditions. The fee should also be steadily increasing over time to provide stronger incentives to borrow or cover the position, with a mandatory buy in after 35 calendar days.[10]

Respectfully submitted,

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[10] The 35 calendar day suggestion is consistent with the closeout requirement in 204(a)(2) on restricted securities awaiting removal of the restriction.