

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR Part 240**

**[Release No. 34-51983; File No. S7-02-04]**

**RIN 3235-AI02**

**Amendments to the Penny Stock Rules**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Final rule.

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

**EFFECTIVE DATE:** September 12, 2005.

**FOR FURTHER INFORMATION CONTACT:** Catherine McGuire, Chief Counsel, Paula R. Jenson, Deputy Chief Counsel, Brian A. Bussey, Assistant Chief Counsel, or Norman M. Reed, Special Counsel, at 202/551-5550, Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, Station Place, 100 F Street, NE, Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** The Securities and Exchange Commission (“Commission” or “SEC”) is adopting 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 January 2004, the Commission proposed amendments to rules under the Exchange Act defining the term “penny stock” and requiring certain broker-dealers to provide certain information to customers regarding penny stock transactions.<sup>1</sup> These proposed amendments were designed to respond to changing market structures, new technology, and legislative developments.

In proposing these amendments, the Commission was particularly concerned with their potential effect on small business capital formation. We recognized the important contributions small companies make to the economy, and stressed that the rule

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<sup>1</sup> Exchange Act Rel. No. 49037 (Jan. 8, 2004), 69 FR 2531 (Jan. 16, 2004).

amendments were not intended to impede the access of small businesses to the capital markets or eliminate viable secondary markets for their securities.<sup>2</sup>

The Commission received a total of 11 comment letters. Commenters included investors, employees of broker-dealers, an attorney, a law school group, the American Stock Exchange LLC (“Amex”), the National Futures Association (“NFA”), and The Nasdaq Stock Market, Inc. (“Nasdaq”).<sup>3</sup> While many commenters generally supported the Commission’s proposals, some expressed concerns regarding particular provisions. We discuss specific comments below in connection with the discussion of the rule amendments.

After carefully considering the comments, the Commission is adopting the rule amendments as proposed with a technical modification to correct a typographical error in the proposal. In particular, we are amending Exchange Act Rule 3a51-1 to provide that securities relying on the exclusions from the definition of penny stock for reported securities, as defined in Exchange Act Rule 11Aa3-1(a), and for certain other exchange-registered securities must either be listed on a “grandfathered” national securities exchange<sup>4</sup> or be listed on a national securities exchange or an automated quotation system sponsored by a registered national securities association (including Nasdaq) that satisfies certain minimum quantitative listing standards.

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<sup>2</sup> See *id.* at 2532.

<sup>3</sup> A detailed comment summary has been prepared by the staff and placed in the Commission’s public files, together with all comment letters received. See File S7-02-04.

<sup>4</sup> An exchange will be “grandfathered” if it has been continuously registered since the Commission initially adopted Rules 15g-1 through 15g-9 under the Exchange Act (collectively known as 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.

In addition, the Commission is amending Rule 3a51-1 to exclude security futures products from the definition of penny stock. We are also eliminating an outdated exclusion for securities quoted on Nasdaq, as well as an outdated provision relating to Amex's Emerging Company Marketplace.<sup>5</sup>

The Commission is also amending Exchange Act Rules 15g-2 and 15g-9 to provide an explicit "cooling-off period" to replace the implicit period that customers traditionally have had when the disclosure documents required by the penny stock rules are provided by postal mail rather than electronically. Moreover, we are amending the penny stock disclosure document (as defined below) and the instructions to it set forth in Schedule 15G under the Exchange Act<sup>6</sup> to update and streamline the document and to make it more useful and easily readable.

Taken as a whole, these 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. Amendments to Rule 3a51-1: Definition of Penny Stock**

Exchange Act Rule 3a51-1 generally defines a penny stock as any equity security. The definition, however, contains a number of broad exclusions for certain equity securities.

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<sup>5</sup> See 17 CFR 240.3a51-1(a).

<sup>6</sup> 17 CFR 240.15g-100.

**A. Reported Securities and Other Exchange-Registered Securities – Minimum Listing Standards**

We proposed to amend paragraph (a) of Rule 3a51-1,<sup>7</sup> which provides an exclusion for reported securities, to require that reported securities must 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 would qualify for the exclusion if the national securities exchange on which it is registered has been continuously registered since April 20, 1992,<sup>8</sup> and the national securities exchange has maintained quantitative initial and continued listing standards that are substantially similar to or stricter than the listing standards that were in place at that exchange on January 8, 2004.<sup>9</sup> Second, a reported security registered on a national securities exchange would qualify for this exclusion if the national securities exchange or a “junior tier” of the exchange has established initial listing standards that meet or exceed the criteria set forth below, and maintains quantitative continued listing standards that are both reasonably related to its initial listing standards and consistent with the maintenance of fair and orderly markets. Third, a reported security listed on an automated quotation system sponsored by a registered national securities association<sup>10</sup> would qualify for this exclusion if the registered national securities association has established initial listing standards for the automated quotation system that meet or exceed the criteria set forth below, and maintains quantitative continued listing standards that are both reasonably

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

<sup>8</sup> This is the date on which the Commission adopted Rule 3a51-1.

<sup>9</sup> We refer to this provision as the “grandfather” provision. *See* Exchange Act Rel. No. 49037, 69 FR at 2534 n. 28 (discussing the use of the term “substantially similar” in this context).

<sup>10</sup> *Id.* at n. 29 (discussing the term “automated quotation system” in this context).

related to its initial listing standards and consistent with the maintenance of fair and orderly markets.<sup>11</sup>

In particular, to qualify for this exclusion for reported securities or the exclusion for certain other exchange-registered securities, 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 initial listing standards that meet or exceed the following criteria:

An issuer must have (1) stockholders’ equity of \$5 million, a market value of listed securities of \$50 million for 90 consecutive days prior to applying for the listing,<sup>12</sup> or net income of \$750,000 (excluding extraordinary or non-recurring items) in the most recently completed fiscal year or two of the last three most recently completed fiscal years; and (2) an operating history of at least one year or a market value of listed securities of \$50 million. In addition, for common or preferred stock, the listing standards must require a minimum bid price of \$4 per share.

For common stock, the initial listing standards must also require at least 300 round lot holders,<sup>13</sup> and at least 1 million publicly held shares with a market value of at least \$5 million.<sup>14</sup> In the case of convertible debt securities, the initial listing standards need to require a principal amount outstanding of at least \$10 million. With respect to rights and warrants, the initial listing standards also must require that at least 100,000

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<sup>11</sup> Id. at n. 30. The securities now listed on Nasdaq do not need a “grandfather” provision because the quantitative listing standards we are adopting are modeled on those currently used by the Nasdaq SmallCap Market.

<sup>12</sup> Market value means the closing bid price multiplied by the number of securities listed.

<sup>13</sup> A round lot holder means a holder of a normal unit of trading.

<sup>14</sup> 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 for purposes of calculating market value in this context.

rights and warrants be issued and that the underlying security be registered on a national securities exchange or listed on an automated quotation system sponsored by a registered national securities association, and satisfy the requirements of paragraphs (a) or (e) of Rule 3a51-1.

For 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 must require that at least 100,000 put warrants be issued and that the underlying security be registered on a national securities exchange or listed on an automated quotation system sponsored by a registered national securities association, and satisfy the requirements of paragraph (a) or (e) of Rule 3a51-1.

With regard to units (that is, two or more securities traded together), the initial listing standards must require that all component parts be registered on a national securities exchange or listed on an automated quotation system sponsored by a registered national securities association, and satisfy the requirements of paragraph (a) or (e) of Rule 3a51-1. Finally, for all other equity securities (including hybrid securities and derivative securities products), the national securities exchange or national securities association must have quantitative initial listing standards that are substantially similar to those outlined above.<sup>15</sup>

Two markets commented on these proposed amendments regarding the exclusion for reported securities. Nasdaq expressed the view that the proposed amendments would undermine the ability of small companies to access capital markets or list their securities

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<sup>15</sup> See Exchange Act Rel. No. 49037, 69 FR at 2534 n. 37. These criteria are modeled on the quantitative criteria currently required by Nasdaq for inclusion in its SmallCap Market.

on viable secondary markets because they would encourage regulatory arbitrage.<sup>16</sup> Specifically, this commenter explained that by essentially adopting the SmallCap Market listing standards as of January 8, 2004 as the baseline criterion for an exemption from the definition of penny stock, and by grandfathering national securities exchanges registered since April 20, 1992, the Commission would create “the opportunity for an issuer to choose a listing venue with laxer standards to secure an exemption from the penny stock rules rather than choosing the venue that provides a more transparent, more liquid and better regulated market for investors.”<sup>17</sup> Nasdaq also expressed concern that these proposals “could impede the ability of established markets to deal with sudden economic and geopolitical events.”<sup>18</sup> In Nasdaq’s view, the proposed amendments to Rule 3a51-1 would mean that some markets would have “a built in advantage memorialized in Commission regulation.”<sup>19</sup> In addition, Nasdaq asserted that an “attempt to freeze listing standards” seems “contrary to the reality that change is an integral component of market evolution.”<sup>20</sup> It also indicated that the Commission was “laboring under the false assumption that the [listing] standards of all markets are substantially the same,” and contrasted its initial listing standards with those of the Amex.<sup>21</sup> Nasdaq suggested amending the proposal to apply “truly uniform standards” across all affected markets and

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<sup>16</sup> See letter from Edward Knight, Executive Vice President, Nasdaq, to Jonathan G. Katz, Secretary, SEC (Mar. 18, 2004) (“Nasdaq letter”). Nasdaq’s comments are discussed in detail below.

<sup>17</sup> Id.

<sup>18</sup> Id.

<sup>19</sup> Id.

<sup>20</sup> Id.

<sup>21</sup> Id. (“For instance, NASDAQ notes that the American Stock Exchange’s (“Amex”) initial listing standard for price is \$3.00 per share, whereas the NASDAQ SmallCap Market standard is \$4.00 per share. Thus, [Nasdaq observes that,] in certain material respects, the SmallCap Market initial listing standards are more stringent than the initial listing standards of the Amex, which would be grandfathered by the proposed definition of a ‘penny stock.’” (citations omitted) ).



exchanges.<sup>22</sup> In Nasdaq’s view, the current overall regulatory structure encourages flexibility while ensuring that the Commission’s absolute oversight of listing standards to avoid potential penny stock abuses in listed securities.<sup>23</sup> Finally, Nasdaq asserted that the current system meets the needs of investors better than a rigid, time-based freeze on listing standards,<sup>24</sup> and asked the Commission to “recognize the value of a flexible model to investors” in the final rules.<sup>25</sup>

In contrast, the Amex was supportive of these proposed rule amendments.<sup>26</sup> Responding to Nasdaq’s comments, the Amex stated that its initial listing standards are, in a number of ways, significantly more stringent than the Nasdaq SmallCap initial listing standards.<sup>27</sup> The Amex also disagreed with Nasdaq’s assertion that the proposed amendments would lead to regulatory arbitrage.<sup>28</sup>

The Pace Investor Rights Project, a law school group at Pace University School of Law, also generally supported the proposed amendments, stating, “We applaud the Commission’s effort to provide an additional level of protection to penny stock investors

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<sup>22</sup> Id.

<sup>23</sup> Id.

<sup>24</sup> Id.

<sup>25</sup> Id. Nasdaq recognized, however, that the Commission could address this concern by granting waivers and exemptions on a case-by-case basis.

<sup>26</sup> See letter from Michael J. Ryan Jr., Executive Vice President and General Counsel, Amex, to Jonathan G. Katz, Secretary, SEC (May 7, 2004) (“Amex letter”) (“The Amex fully supports the Commission’s continuing efforts to deter fraud in the penny stock market.”).

<sup>27</sup> Id. (“While SmallCap imposes a higher price requirement, a full comparison of the initial listing standards for both marketplaces reveals that the Amex standards in the aggregate subject issuers to a broader range of quantitative criteria. Specifically, the Amex standards require compliance with at least two core quantitative criteria (e.g., shareholders’ equity, pre-tax income, market capitalization, market value of publicly held shares) and/or with enhanced quantitative criteria, while the SmallCap standards require compliance with only one core quantitative criteria.”).

<sup>28</sup> Id. (“As discussed above, the Nasdaq claim that the SmallCap listing standards are more stringent than the Amex listing standards is flawed, and accordingly we do not agree that the proposal would result in a regulatory arbitrage or encourage issuers to choose an Amex listing.”).

by amending Rule 3a51-1 to add minimum quantitative standards for exclusion from the definition of a penny stock.”<sup>29</sup> This commenter specifically noted that “the proposed balance sheet or income statement criteria specified in [the proposed amendments to Rule] 3a51-1(a) should help distinguish excluded securities from those securities appropriately falling within the penny stock rules,” and stated that “initial listing and continued listing standards will enhance investor protection.”<sup>30</sup> This commenter also suggested that “improved protections might flow to general investors who make unsolicited transactions and rely to some degree on whether a security is properly classified as a penny stock or not.”<sup>31</sup>

We have carefully considered the comments, and particularly Nasdaq’s suggestion that the proposed rule amendments may foster regulatory arbitrage. We continue to believe that the rule amendments preserve – not change – the status quo with respect to existing markets. The amendments should not encourage or facilitate regulatory arbitrage because they explicitly provide for the “grandfathering” of reported securities on existing national securities exchanges. Moreover, the amendments

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<sup>29</sup> See letter from Barbara Black, Director, Jill I. Gross, Director, and Bob Kim, Student Intern, Pace Investor Rights Project, to Jonathan G. Katz, Secretary, SEC (Mar. 11, 2004) (“Pace letter”).

<sup>30</sup> Id. As we noted when we proposed these amendments, 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 will 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. See Exchange Act Rel. No. 49037, 69 FR at 2535.

We wish to stress that 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.

<sup>31</sup> Id. In addition, this commenter expressed concern that the proposed amendments to Rule 3a51-1 may not be sufficient to protect first time penny stock investors participating in solicited transactions.

implicitly “grandfather” Nasdaq because the minimum baseline for listing standards we are adopting today is modeled on the quantitative standards currently used by the Nasdaq SmallCap Market. As a result, the rule amendments should have no impact on the competitive positions of existing markets as compared to the current rule. In effect, only new markets or new “junior tiers” of existing national securities exchanges will be required to satisfy the minimum baseline for listing standards described above.

While we appreciate Nasdaq’s preference for the current regulatory structure, and its view that national securities exchanges and automated quotation systems operated by national securities associations should have flexibility with respect to their listing standards, we do not view these amendments as fostering inflexibility, or as altering the current regulatory structure. National securities exchanges and Nasdaq will retain their ability to establish and change their listing standards. Moreover, as with other self-regulatory organization (“SRO”) rules, we will review any proposed changes to SRO listing standards for compliance with the requirements of the Exchange Act<sup>32</sup> and Rule 19b-4 thereunder.<sup>33</sup> Any proposed changes that would tighten a market’s listing standards would have no effect on the penny stock status of securities listed on that market. We will also review any proposed changes that would dilute a market’s listing standards and consider, among other things, whether such proposed rule changes might encourage any potential penny stock-type abuses in reported securities. In addition, in the event that an exchange or Nasdaq decided to lower any particular listing standards

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<sup>32</sup> See 15 U.S.C. 78s(b).

<sup>33</sup> 17 CFR 240.19b-4.

below the standards established in this rule,<sup>34</sup> it could request an exemption from the Commission pursuant to Exchange Act Rule 15g-1.<sup>35</sup>

Similarly, we can utilize exemptive authority to deal with sudden economic and geopolitical events, as we did in the days immediately following the market disruptions caused by the events of September 11, 2001. At that time, we issued emergency orders under Section 12(k)(2) of the Exchange Act.<sup>36</sup>

While we have considered the suggestion that we adopt a rule requiring “truly” uniform standards across all markets and exchanges, we believe that such an approach is inappropriate because it would require the Commission, as opposed to the markets, to establish listing standards. Such an approach would eliminate the flexibility SROs have to establish listing standards and undermine competition among markets on the basis of listing standards. In addition, the rule amendments we are now adopting permit Nasdaq and the “grandfathered” national securities exchanges to continue to operate as they currently do. Forcing all national securities exchanges and Nasdaq to adopt uniform

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<sup>34</sup> To the extent its current listing standards exceed those in Rule 3a51-1, Nasdaq or an exchange could lower its listing standards without necessarily losing its reported securities’ exclusion from the definition of penny stock.

<sup>35</sup> 17 CFR 15g-1(f) (The Commission may exempt from Rules 15g-2 through 15g-6 “[a]ny other transaction or class of transactions or persons or class of persons . . . as consistent with the public interest, and the protection of investors”). Paragraph (c)(1) of Rule 15g-9 excludes transactions covered by Rule 15g-1(f) (“For purposes of this section, the following transactions shall be exempt: (1) Transactions that are exempt under 17 CFR 240.15g-1(a), (b), (d), (e), and (f).”).

Moreover, Section 36 of the Exchange Act [15 U.S.C. 78mm] grants the Commission general exemptive authority to the extent that such exemptions are necessary or appropriate in the public interest, and are consistent with the protection of investors.

<sup>36</sup> Section 12(k)(2) of the Exchange Act [15 U.S.C. 78l(k)(2)] states that, when certain conditions are met, “[t]he Commission, in an emergency, may by order summarily take such action to alter, supplement, suspend, or impose requirements or restrictions, with respect to any matter or action subject to regulation by the Commission or a self-regulatory organization under [the Exchange Act], as the Commission determines is necessary in the public interest and for the protection of investors . . . .” See, e.g., Exchange Act Rel. Nos. 44791 (Sept. 14, 2001), 66 FR 48494 (Sept. 20, 2001); and 44827 (Sept. 21, 2001), 66 FR 49438 (Sept. 27, 2001) (temporarily easing the conditions of Exchange Act Rule 10b-18, the safe harbor for issuer repurchases).

listing standards – standards formulated by the Commission and untested in the real world – would be disruptive to established markets and impose unnecessary costs.

Hence, we decline to adopt this suggestion.

We find that the proposed amendments to Rule 3a51-1(a) are consistent with the public interest and the protection of investors, and are adopting them with a technical modification to correct a typographical error in the proposal. As adopted, therefore, Rule 3a51-1(a)(2)(i)(H) will provide that the security underlying the put warrants must be “registered on a national securities exchange or listed on an automated quotation system sponsored by a registered national securities association and satisfy the requirements of paragraph (a) or (e) of this section.”

These amendments will create a more meaningful distinction between securities that should be subject to the penny stock rules and those of more substantially capitalized issuers. They will therefore help ensure that we can continue to carry out Congress’s stated goals with respect to penny stocks, as set forth in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (“Penny Stock Reform Act”), regardless of changes in markets or market structures.<sup>37</sup>

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<sup>37</sup> See Pub. L. No. 101-429, 104 Stat. 931 (1990); Exchange Act Rel. No. 30608 (Apr. 20, 1992), 57 FR 18004 (Apr. 28, 1992). Among other things, Congress found when it enacted the Penny Stock Reform Act that:

“ . . . (2) Protecting investors in new securities is a critical component in the maintenance of an honest and healthy market for such securities.

(3) Protecting issuers of new securities and promoting the capital formation process on behalf of small companies are fundamental concerns in maintaining a strong economy and viable trading markets.”

Penny Stock Reform Act, Sec. 502 [15 U.S.C. 78o note].

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

We also proposed eliminating the exclusion in paragraph (f) of Rule 3a51-1 for certain securities quoted or authorized for quotation on Nasdaq upon notice of issuance because we believe it no longer serves any purpose.<sup>38</sup> We requested comment on this proposal.<sup>39</sup>

One commenter agreed with the proposed elimination of paragraph (f) of Rule 3a51-1 on the grounds that SmallCap Market securities are now reported securities within the meaning of paragraph (a) of Rule 3a51-1.<sup>40</sup> Another commenter noted that it had no objection to this change.<sup>41</sup> We find that the proposed amendment to Rule 3a51-1(f) is consistent with the public interest and the protection of investors, and are, therefore, adopting it without modification.

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

We proposed amending Rule 3a51-1 to add 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>42</sup> This approach is consistent with the treatment of options under the penny stock rules.<sup>43</sup>

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<sup>38</sup> See Exchange Act Rel. No. 49037, 69 FR at 2536 (recognizing that since 2001 SmallCap Market securities have been reported securities because they are securities reported pursuant to a transaction reporting plan approved by the Commission).

<sup>39</sup> Id.

<sup>40</sup> See letter from Donald J. Stoecklein, Stoecklein Law Group, to Jonathan G. Katz, Secretary, SEC (Mar. 15, 2004) (“Stoecklein letter”).

<sup>41</sup> See Pace letter, supra at n. 29.

<sup>42</sup> See Exchange Act Rel. No. 49037, 69 FR at 2536. Security futures products are subject to a special 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. 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

Two commenters addressed this proposed amendment. The NFA agreed with the Commission's analysis, and supported this proposed amendment.<sup>44</sup> In addition, the Pace Investor Rights Project indicated that it had no objection to this proposed amendment.<sup>45</sup> We find that this proposed amendment to Rule 3a51-1 is consistent with the public interest and the protection of investors, and are, therefore, adopting it without modification.

#### **D. Other Amendments to Rule 3a51-1**

We also proposed eliminating the exception in paragraph (a) of Rule 3a51-1 for Amex's Emerging Company Marketplace<sup>46</sup> because it no longer exists.<sup>47</sup> We received no comment regarding this proposed amendment. We find that this proposed amendment is consistent with the public interest and the protection of investors, and are, therefore, adopting it without modification.

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NFA Compliance Rule 2-30(b). Subjecting security futures products to the additional disclosure requirements of the penny stock rules, therefore, would likely be duplicative and unnecessarily burdensome.

<sup>43</sup> In particular, the term "penny stock" currently does not include any put or call options issued by the Options Clearing Corporation ("OCC"). See 17 CFR 240.3a51-1(c). This exclusion recognizes that the put and call options issued by the OCC are subject to special disclosure requirements. See Exchange Act Rel. No. 30608 (Apr. 20, 1992), 57 FR 18004, 18010 n. 39 (Apr. 28, 1992) ("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; and NASD Rule 2860(b)(16).

<sup>44</sup> See letter from Thomas W. Sexton, Vice President and General Counsel, National Futures Association, to Jonathan G. Katz, Secretary, SEC (Mar. 15, 2004) ("Security futures products are subject to a comprehensive regulatory scheme that provides customers with protections that are at least as stringent as the protections provided by the Commission's penny stock rules.").

<sup>45</sup> See Pace letter, *supra* at n. 29.

<sup>46</sup> This exception provides that any security that is listed on the Amex pursuant to the listing criteria of the Emerging Company Marketplace, but that does not satisfy the requirements of paragraph (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>47</sup> See Exchange Act Rel. No. 49037, 69 FR at 2532 n. 11.

In addition, we proposed amending the exclusion for certain other exchange-registered securities provided by paragraph (e) of Rule 3a51-1<sup>48</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>49</sup> We also proposed amending the exception in paragraph (e) of Rule 3a51-1<sup>50</sup> to make clear that a security that satisfies the requirements of paragraph (e) and also satisfies the requirements of paragraph (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>51</sup> Only one commenter explicitly addressed these proposed amendments to paragraph (e) and this commenter stated it had no objections to them.<sup>52</sup> We find that these proposed amendments are consistent with the public interest and the protection of investors, and are, therefore, adopting them without modification.

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<sup>48</sup> 17 CFR 240.3a51-1(e). See Exchange Act Rel. No. 49037, 69 FR at 2534.

<sup>49</sup> Id. at 2534 n. 34. We explained when we proposed these amendments that, as a result of these 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 standard requirements that we are adopting in order to qualify for either exclusion from the definition of penny stock. We noted, however, that in adopting these amendments, the Commission was not expressing a view regarding the pending application for registration of Nasdaq as a national securities exchange.

<sup>50</sup> Id. at 2534. As originally adopted, this exception provides that a security that satisfies the requirements of paragraph (e), but that does not otherwise satisfy the requirements of paragraph (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>51</sup> New paragraph (f), discussed above, will provide an exclusion for security futures products. See Exchange Act Rel. No. 49037, 69 FR at 2534 n. 36. We noted when we proposed these amendments that it would be appropriate to expand the exception in paragraph (e) to include this new exclusion for security futures products. As a result, security futures products will be treated in the same way as put or call options issued by the OCC for purposes of the exception in paragraph (e). We also explained that the expansion of the exception in paragraph (e) to include paragraph (g) was intended to clarify a potential ambiguity in the rule, and it was not intended to be a substantive change to the rule.

<sup>52</sup> See Pace letter, supra at n. 29.



### **III. Amendments to Rules 15g-2 and 15g-9**

#### **A. Background**

##### **1. Rule 15g-2**

Rule 15g-2(a) makes it unlawful for a broker-dealer to effect a transaction in a penny stock with or for the account of a customer unless the broker-dealer distributes to the customer, prior to effecting a transaction in a penny stock, a disclosure document, as set forth in Schedule 15G,<sup>53</sup> and receives a signed and dated acknowledgement of receipt of that document from the customer in tangible form.<sup>54</sup> The document (“penny stock disclosure document”), which must contain the information set forth in Schedule 15G, 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 advisors, that investors should compare information from the salesperson with other information on the penny stock, and that investors in penny stocks should be prepared for the possibility of losing their whole investment.

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<sup>53</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>54</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.”

2. Rule 15g-9

Rule 15g-9, which was originally adopted as Rule 15c2-6 under the 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>55</sup> Rule 15g-9 generally prohibits a broker-dealer from selling a penny stock 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.<sup>56</sup>

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>57</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

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<sup>55</sup> See Exchange Act Rel. No. 49037, 69 FR at 2538 n. 68 (discussing Exchange Act Rule 15c2-6).

<sup>56</sup> See 17 CFR 240.15g-9.

<sup>57</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:

\* \* \*

(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.

conversation with a salesperson. It removes the pressure for an immediate decision.<sup>58</sup>

We believe this requirement is critical to the effectiveness of the rule.<sup>59</sup>

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>60</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>61</sup>

## **B. Amendments to Rules 15g-2 and 15g-9**

The amendments to Rule 15g-2(b) will impose a uniform waiting period of two business days that can 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.<sup>62</sup> As amended, the rule will make it unlawful for a broker-dealer to effect a transaction in a penny stock for or with the account of a customer unless, prior to

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<sup>58</sup> See Exchange Act Rel. No. 49037, 69 FR at 2538 n. 72 (explaining that Rule 15c2-6 was designed to interfere with the cold-calling sales tactics of "boiler room" operations).

<sup>59</sup> Id. (explaining that the written agreement requirement was intended to ensure that a customer's final decision would be made outside of a pressuring telephone call and that it was also intended to provide objective evidence of whether a customer agreed to a penny stock transaction).

<sup>60</sup> Id. at 2538.

<sup>61</sup> Id.

<sup>62</sup> See 17 CFR 240.15g-2(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 a penny stock for or with the account of a customer less than two business days after the broker or dealer sends such document.").

effecting the transaction, the broker-dealer distributes to the customer a penny stock disclosure document, and has obtained from the customer a signed and dated acknowledgement of receipt of that document.<sup>63</sup> The amendments to Rule 15g-2 are designed to preserve parity between electronic and paper communications in the context of the disclosure requirements of the penny stock rules.

We are also amending Rule 15g-9 to provide that a broker-dealer cannot execute the relevant penny stock transaction until at least two business days after it has sent the suitability statement required by Rule 15g-9(b)<sup>64</sup> and the agreement to the transaction in a penny stock required by Rule 15g-9(a)(2)(ii)<sup>65</sup> electronically or by mail or some other paper-based means. The amended rule will continue to require that the broker-dealer receive these signed documents, in either electronic<sup>66</sup> or paper form, back from the customer before executing the transaction.<sup>67</sup> As with the amendments to Rule 15g-2, the amendments to Rule 15g-9 are designed to preserve parity between electronic and paper communications in the context of the disclosure requirements of the penny stock rules.

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<sup>63</sup> See 17 CFR 240.15g-2(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.”).

<sup>64</sup> See 17 CFR 240.15g-9(b)(4)(ii) (“Regardless of the form of the 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.”).

<sup>65</sup> See 17 CFR 240.15g-9(a)(2)(ii)(B) (“Regardless of the form of the 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.”).

<sup>66</sup> See Exchange Act Rel. No. 49037, 69 FR at 2540 n. 96 (noting 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>67</sup> The amendments require that the broker-dealer continue to receive: (1) a signed and dated suitability statement as required under Rule 15g-9(b); and (2) an agreement to a transaction in a penny stock as required by Rule 15g-9(a)(2)(ii).

We received three comments regarding the proposed amendments to Rules 15g-2 and 15g-9. Two commenters were generally supportive,<sup>68</sup> while one commenter was opposed to the changes to these rules.<sup>69</sup>

The Pace Investor Rights Project generally supported the proposed amendments, but expressed the view that the proposed two-business day waiting period is inadequate because it is too short. In this commenter's opinion, the penny stock disclosure document required by Rule 15g-2 and the suitability statement required by Rule 15g-9 are the two most important vehicles for informing and educating the first-time penny stock investor. This commenter suggested a minimum five-business day waiting period, asserting that this longer period would provide sufficient time for the customer to reflect fully upon the proposed transaction, read the documentation, and seek additional information without sales pressure.<sup>70</sup>

Another commenter approved of the proposed amendments but suggested a two-calendar day waiting period instead of a two-business day waiting period, indicating that a weekend or a holiday period would provide an adequate cooling-off period. This commenter also suggested that the cooling-off period commence on receipt of the document back from the customer, because, at least with regard to electronic documents, there are verifiable electronic means of determining the exact time of receipt.<sup>71</sup>

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<sup>68</sup> See Pace letter, *supra* at n. 29, and Stoecklein letter, *supra* at n. 40.

<sup>69</sup> See letter from Mark Beloyan to Jonathan G. Katz, Secretary, SEC (Mar. 15, 2004) ("Beloyan letter").

<sup>70</sup> See Pace letter.

<sup>71</sup> See Stoecklein letter.

In contrast, a representative of a broker-dealer characterized the proposed two-business day waiting period as “ridiculous.”<sup>72</sup> In his view, the amendments were not practical because, by waiting two business days, a broker would not be giving his client best execution. Moreover, the commenter stated that the broker’s client would be upset if the price of the stock the broker recommended increased during this two-day waiting period. The commenter also indicated that, rather than waiting, the client would decide to buy the stock through an Internet account as an unsolicited order and get immediate execution.<sup>73</sup>

After carefully considering the comments, we are adopting the two-business day waiting period as proposed. We believe that this time period effectively preserves the status quo by replicating the time it would take for postal delivery of the documents required by Rules 15g-2 and 15g-9.<sup>74</sup>

While we appreciate the suggestions to expand the waiting period to five business days or constrict it to two calendar days, we are not persuaded that either suggestion would provide superior protections to investors. We believe that two business days is sufficiently long period of time for potential penny stock investors to reflect on a proposed transaction, and that a five-business day waiting period would unnecessarily impair investors’ ability to engage in transactions that they choose to complete.

Moreover, neither a five-business day waiting period nor a two-calendar day waiting period would replicate the cooling-off period of postal mail. Our intention in

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<sup>72</sup> See Beloyan letter (emphasis in original).

<sup>73</sup> Id. This commenter stated that “timing is the main component of the stock market and if you take timing away from brokers then you take the ability to trade and this doesn’t serve the investment community.”

<sup>74</sup> See Exchange Act Rel. No. 49037, 69 FR at 2536 and 2548.

proposing these amendments was to provide investors with the same cooling-off period, regardless of the means of communication. A two-business day waiting period accomplishes this. For the same reason, we decline to adopt the suggestion to commence the cooling-off period on receipt of the document back from the customer. We continue to believe that the appropriate time to begin the waiting period is when the documents are sent by the broker-dealer.<sup>75</sup>

With respect to the concerns expressed by the representative of the broker-dealer, we believe that they do not reflect the limited circumstances in which Rules 15g-2 and 15g-9 apply.<sup>76</sup> As we discussed in detail when we proposed these rule amendments, the rules are 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. In addition, as noted above, we do not believe that the explicit waiting periods imposed under these amendments will increase the existing burdens under the penny stock rules. Indeed, with respect to communications sent through the mail, the rules already effectively impose a similar waiting period.

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<sup>75</sup> Id. at 2540.

<sup>76</sup> Id. at 2537-38. Most notably, these rules would not apply 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. See Rule 15g-1(a) [17 CFR 240.15g-1(a)]. In addition, 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. See Rules 15g-1(b) and (e) [17 CFR 240.15g-1(b) and (e)]. Moreover, 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. See Rules 15g-9(c)(3) and 15g-9(d)(2) [17 CFR 240.15g-9(c)(3) and 240.15g-9(d)(2)].

One commenter expressed concern regarding e-mail-only delivery and acknowledgement, or web-based methods requiring only a single click or response as a means of satisfying the requirements of the penny stock rules.<sup>77</sup> In this commenter's view, hard copy delivery is more effective for initial educational and cooling-off purposes.<sup>78</sup>

Although we understand this commenter's concerns, we originally addressed this issue in our 1996 electronic media release, which provided guidance to broker-dealers, transfer agents, and investment advisers regarding the use of electronic media to fulfill their delivery obligations under the federal securities laws. Among other things, we explicitly allowed broker-dealers to meet their delivery obligations under the penny stock rules by electronic means.<sup>79</sup> We specifically determined, however, that broker-dealers should continue to obtain from customers signatures and agreements in tangible form under the penny stock rules.<sup>80</sup> Congress subsequently determined in the Electronic Signatures in Global and National Commerce Act ("Electronic Signatures Act") that no signature, contract, or other record relating to a transaction in interstate or foreign

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<sup>77</sup> See Pace letter, supra at n. 29.

<sup>78</sup> Id. ("We believe that hard copy delivery will be more effective for initial educational and cooling-off purposes. In particular, we believe it is very important for customers to review the broker's suitability determination. In general, we do not support email-only delivery and acknowledgment approaches or web-based methods requiring only a single click or response.").

<sup>79</sup> See Exchange Act Rel. No. 37182 (May 9, 1996), 61 FR 24644, 24649 n. 50 (May 15, 1996) ("While broker-dealers may not meet the signature requirement under Rule 15g-9 by electronic means, the Commission believes that, consistent with the guidance set forth in this interpretation, they may meet their delivery obligations to their customers under this rule by electronic means. The risk disclosure document that broker-dealers are required to furnish to their customers under Rule 15g-2 is subject to strict formatting and typefacing restrictions. In order to comply with the requirements set forth in the instructions to Schedule 15G, a risk disclosure document delivered electronically, when printed, would have to result in a document that meets the requirements and contains the exact text of Schedule 15G.").

<sup>80</sup> Id. at 24646 n. 12 ("[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.").



commerce may be denied legal effect, validity or enforceability solely because it is in electronic form.<sup>81</sup> Implementation of the provisions of the Electronic Signatures Act in the context of Exchange Act Rules 15g-2 and 15g-9 requires us to strike a balance between facilitating the use of electronic communications, as contemplated by the Electronic Signatures Act, and maintaining the important investor protections of the Penny Stock Reform Act.<sup>82</sup>

Moreover, we believe that this commenter's concern about an acknowledgment procedure consisting of simply a single click or response is largely addressed by existing requirements of the penny stock rules. Investors must acknowledge the receipt of three separate documents pursuant to Rules 15g-2 and 15g-9. We believe that three separate documents and the acknowledgment procedures they require should alert investors to the significance of their decision to invest in a penny stock.<sup>83</sup> In addition, as discussed below, we are also adopting amendments to Schedule 15G designed to ensure that the disclosure, in the case of electronic transmission, is clear and meaningful. Specifically,

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<sup>81</sup> See Pub. L. 106-229, 114 Stat. 464 (2000) (codified at 15 U.S.C. 7001 et seq. (2001)).

<sup>82</sup> See Exchange Act Rel. No. 49037, 69 FR at 2539 n. 90. In that footnote, we explained that we were expressing 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: (1) 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 (2) the Rule 15g-2 requirement that customers provide a signed and dated acknowledgement of receipt of the penny stock disclosure document.

<sup>83</sup> We believe that there should be separate acknowledgment procedures for each document required by Rules 15g-2 and 15g-9 and that these procedures must provide a meaningful opportunity for investors to review all of the information being provided to them before acknowledging receipt of each document. For example, before providing an investor with an opportunity to acknowledge receipt, the entire document should be provided to the investor in clear, easy-to-read type reasonably calculated to draw the investor's attention to the language in the document. For longer documents, an investor should be required to scroll through the entire document before being able to acknowledge receipt of the document. As a result, we do not believe it would be appropriate for firms to permit investors to acknowledge the receipt of all three documents by means of a single click.

the first paragraph of the penny stock disclosure document tells investors that it contains important information and that they should read it carefully before they sign it and before they decide to purchase or sell a penny stock.

#### **IV. Amendments to Schedule 15G**

We proposed a number of amendments to the penny stock disclosure document and its instructions set forth in Schedule 15G.<sup>84</sup> The proposed amendments were intended to modernize the document and make it more readable and more useful to potential penny stock investors.<sup>85</sup> In particular, we proposed eliminating specific references to Nasdaq such as “quoted on NASDAQ,” “quoted on the NASDAQ system” or “quoted on the NASD’s automated quotation system.” We also proposed revising the document, consistent with the amendments to Rule 3a51-1 discussed above, to inform investors that penny stocks may trade on facilities of national securities exchanges and foreign exchanges. In addition, we proposed revising the penny stock disclosure document so that it would inform penny stock customers of the procedures, including waiting periods, to be followed in light of the amendments to Rules 15g-2 and 15g-9. We also proposed adding the Internet addresses for the Commission, National Association of Securities Dealers, Inc. (“NASD”), and the North American Securities Administrators Association, Inc.

Moreover, we proposed to significantly reorganize the penny stock disclosure document to make it more readable to investors. The original penny stock disclosure

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<sup>84</sup> See 17 CFR 240.15g-100.

<sup>85</sup> See Exchange Act Rel. No. 49037, 69 FR at 2542 (explaining that the current penny stock disclosure document was written over a decade ago and reflects the market as it existed at that time, and that the proposed revisions to the penny stock disclosure document would bring it up-to-date, and also make it more streamlined and understandable to investors).

document was divided into two parts. The first part set forth in a single page the items required to be disclosed pursuant to Section 15(g)(2) of the Exchange Act (“Summary Document”).<sup>86</sup> The second part supplemented and explained in greater detail the information provided in the Summary Document (“Explanatory Document”).<sup>87</sup> We proposed to 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.<sup>88</sup>

We also proposed revising Schedule 15G so that it would provide instructions regarding how to electronically provide the penny stock disclosure document to investors.<sup>89</sup> For broker-dealers that electronically send their customers a penny stock disclosure document, the amendments we are adopting will require the e-mail containing the penny stock disclosure document 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 and easy to read. When information is required to be printed in bold-face type, underlined, or capitalized, the proposed amendments to the rule

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<sup>86</sup> Id. at 2541.

<sup>87</sup> Id.

<sup>88</sup> 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 achieves 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. See Exchange Act Rel. No. 49037, 69 FR at 2541. See also Exchange Act Rel. No. 30608, 57 FR at 18017-18 (discussing the penny stock disclosure document).

<sup>89</sup> In addition to the proposed instructions, the use of electronic media to provide the document is subject to applicable legal requirements. See Exchange Act Rel. No. 49037, 69 FR at 2539 n. 90.

would allow issuers to satisfy such requirements by presenting the information in any manner reasonably calculated to draw attention to it.<sup>90</sup>

We also proposed permitting the penny stock disclosure document to be sent electronically using a hyperlink to where the document is located on the Commission's Web site. Pursuant to the adopted amendments, the e-mail containing the hyperlink will need to have as a subject line: "Important Information on Penny Stocks." Immediately before the hyperlink, the text of the e-mail will 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. Please read it carefully before you agree to purchase or sell a penny stock."

Furthermore, we are adopting amendments that will require 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 to provide the name, address, e-mail address and telephone number of the broker sending the message. No other information can 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.<sup>91</sup>

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<sup>90</sup> Id. at 2542 n. 103 (explaining that 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 also Exchange Act Rel. No. 37183 (May 9, 1996), 61 FR 24652 (May 15, 1996).

<sup>91</sup> Id. at 2542.

We received two comments regarding the proposed changes to the penny stock disclosure document and the instructions in Schedule 15G. One commenter generally supported the proposed changes to the penny stock disclosure document, but expressed concern regarding the dissemination of this document via hyperlink, unless the hyperlink is part of a comprehensive, multi-step on-line delivery and acknowledgement procedure.<sup>92</sup> This commenter also viewed hard copies as preferable to electronic copies, and urged the Commission to require brokers-dealers to send customers a hard copy of the expanded information available on the Commission's Web site, unless the customer explicitly requests otherwise.<sup>93</sup>

We have considered these suggestions in light of the increasingly electronic nature of commerce in general and the securities industry in particular.<sup>94</sup> As noted previously in this release, we determined in our 1996 electronic media release that broker-dealers could satisfy the delivery requirements of the penny stock rules 15g-2 and 15g-9 by means of electronic media.<sup>95</sup> Moreover, we continue to believe that providing a hyperlink is an efficient method of alerting potential penny stock investors to the existence of the Commission's Web site and providing them with ready access to the useful information on our Web site about investing in penny stocks and microcap

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<sup>92</sup> See Pace letter, supra at n. 29 (“We applaud the Commission’s proposed effort to simplify and streamline the penny stock disclosure document. We generally approve of the revised content and, in particular, we are pleased with the inclusion of toll-free numbers for regulatory agencies.”).

<sup>93</sup> Id.

<sup>94</sup> In our 1996 electronic media release, we noted that the electronic distribution of information provides numerous benefits and the use of electronic communications is growing among all participants in securities transactions. See Exchange Act Rel. No. 37182, 61 FR at 4645 (citing Securities Act Rel. No. 7233 (Oct. 6, 1995), 60 FR 53458 (Oct. 13, 1995)).

<sup>95</sup> See supra at n. 79.

securities.<sup>96</sup> In addition, under the amended rules, a broker-dealer would be required to provide a customer, upon request, with a copy of the additional information regarding microcap securities, including penny stocks, from the Commission's Web site.<sup>97</sup>

Another commenter urged the Commission to be prescriptive and to specify in detail how the penny stock disclosure document should appear electronically, rather than allowing the information to be presented in a manner reasonably calculated to draw attention to it.<sup>98</sup> While we appreciate the commenter's concerns, we believe that an attempt to impose this kind of uniformity through exacting technical requirements would be both burdensome and impractical in light of the variety of software and hardware employed by broker-dealers. Rather than requiring uniformity, we have attempted to balance broker-dealers' implementation and ongoing costs with the benefits to investors. We do, however, expect broker-dealers to use this flexibility to craft clear and easily accessible penny stock disclosure documents.<sup>99</sup>

One commenter also suggested that the disciplinary history of a broker or firm could be provided as part of the initial disclosures.<sup>100</sup> While we understand the goal of

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<sup>96</sup> This approach permits investors to better analyze the penny stock transaction being offered to them since they will have access not only to the portion of the Commission's Web site that deals with investing in penny stocks and microcap securities, but also 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 perhaps better educate him or herself before making an investment decision. As we noted in our 2000 electronic media release, "One of the key benefits of electronic media is that information can be disseminated to investors and the financial markets rapidly and in a cost-effective and widespread manner." See Exchange Act Rel. No. 42728 (Apr. 28, 2000), 65 FR 25843, 25844 (May 4, 2000).

<sup>97</sup> See Exchange Act Rel. No. 49037, 69 FR at 2542.

<sup>98</sup> See Stoecklein letter, supra at n. 40 ("We believe that the Commission should be prescriptive and specify in detail how the proposed disclosure document should appear electronically, as opposed to allowing the satisfaction of the requirements by 'presenting the information in any manner reasonably calculated to draw attention to it.' This would provide consistency in the disclosure documentation and avoid misunderstanding or further clarification in the future.").

<sup>99</sup> See Exchange Act Rel. No. 49037, 69 FR at 2542 n. 103.

<sup>100</sup> See Pace letter, supra at n. 29.

trying to provide investors with information they may need in one comprehensive package, we believe that the penny stock disclosure document, as proposed, gives investors clear information about how they can easily seek out disciplinary history from NASD or their state securities official – either by telephone or via the Internet. The document also urges investors to ask about the disciplinary history of the broker and the firm with whom they are dealing. Although we could adopt the commenter’s suggestion and require firms to provide this information, we believe that the procedure we are adopting today will better serve investors than such an approach. Encouraging investors to contact the NASD or their state securities regulator will not only help investors to obtain more up-to-date information, but also assist them in obtaining more comprehensive information than they might get from a broker-dealer. Moreover, requiring that such information be included in the penny stock disclosure document would undercut our goal of making the document more succinct and therefore more readable and useful to investors.<sup>101</sup>

We have, therefore, decided to adopt the amendments to the penny stock disclosure document and the instructions to it set forth in Schedule 15G as proposed. These amendments recognize and keep pace with changes in communications technology over the past decade by continuing to provide potential penny stock investors with important information before a sale takes place. These amendments will enable investors

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<sup>101</sup> Significantly, when we adopted the penny stock rules some commenters suggested that a description of the type of disciplinary history available from the NASD and the North American Securities Administrators Association, Inc. be included in the penny stock risk disclosure document. We declined to do so at that time because we believed that such a specific explanation might be confusing to the ordinary investors. See Exchange Act Rel. No. 30608, 57 FR at 18018 n. 113.

and the broker-dealers with whom they do business to comply with the requirements of Rules 15g-2 and 15g-9 while using modern methods of electronic communication.

## V. Other Comments

One commenter expressed concern that the penny stock rules interfere with investors' ability to make risky investments and to speculate.<sup>102</sup> Notably, in adopting the predecessor to Rule 15g-9, the Commission explained, "The target of the Rule [15c2-6] 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>103</sup> These amendments are designed to maintain the existing penny stock rule protections. This commenter also questioned the effect of the rule amendments on venture capital and small public companies, but did not provide any supporting information.<sup>104</sup>

Another commenter suggested that the "transaction agreement" include: (1) an up-to-date list of market makers for the solicited stock; and (2) a recent market share

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<sup>102</sup> See Beloyan letter, supra at n. 69 ("[Investors] know what they are doing and they know they want to risk some of their capital for a potential big reward or even want the chance to win big if the[y] [sic] find the next Microsoft, Cisco, [sic] IBM. Why does the SEC want to take that away from consenting adults? If an investor has bought penny stocks before at another firm and wants to do business with me in penny stocks, he still has to fill out the existing forms, why make him wait 2 days and jump through all those hoops?").

<sup>103</sup> Exchange Act Rel. No. 27160 (Aug. 22, 1989), 54 FR 35468, 35479 (Aug. 28, 1989). When Congress adopted the Penny Stock Reform Act, it explicitly endorsed Rule 15c2-6. 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. (Jul. 23, 1990) (reporting H.R. 4497) at 7 ("This legislation amends both the Securities Exchange Act of 1934 (Exchange Act) and the Securities Act of 1993 (Securities Act) and issues legislative directives with the intention of curbing the pervasive fraud and manipulation of the penny stock market. . . . The Committee supports the ongoing initiatives of the Commission in combating penny stock fraud, including its adoption in August 1989 of its penny stock cold calling rule, Rule 15c2-6, under the Exchange Act.").

<sup>104</sup> See Beloyan letter, supra at n. 69.



volume report indicating whether the soliciting broker is among the most active market makers in the solicited stock.<sup>105</sup> In addition, this commenter suggested that broker-dealers should be required to provide transaction agreements for a minimum time period, perhaps two months, unless two conditions are met: (1) three qualifying transactions have taken place; and (2) the customer opts out of the requirement by electing, in writing, to no longer receive and signs a transaction agreement.<sup>106</sup>

While we appreciate this commenter’s thoughtful suggestions, our goal in this rulemaking is only to update the penny stock rules and ensure that they continue to provide the protections they have in the past decade despite changing market structures, new technology, and legislative developments. We, therefore, decline at this time to impose any additional requirements on broker-dealers.

Another commenter stated that the proposed amendments are extremely hard to understand, and suggested that they be simplified.<sup>107</sup> While we recognize that the penny stock rules are complex, we note that broker-dealers that do not solicit penny stock transactions are exempt from the rules’ requirements. The penny stock rules are 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. While we are committed to “plain English” and regulatory simplification to the

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<sup>105</sup> See Pace letter, supra at n. 29.

<sup>106</sup> Id.

<sup>107</sup> See letter from Jerry Seale, Investment Representative, BSC Securities, to Jonathan G. Katz, Secretary, SEC (Mar. 15, 2004) (“With all due respect, the proposed regulations are extremely hard to understand. My suggestion is to simplify the rules in a summary form. You shouldn’t have to have a law degree or spend 3 or 4 days in deep study to understand what is required. My interest in this rule is only to properly educate investors who come to me wanting to buy penny stocks. I never have solicited them.”).

extent possible, broker-dealers that choose to engage in this particular business should be prepared to adhere to the requirements of the penny stock rules.

Moreover, two commenters expressed concern about short selling activity in penny stocks.<sup>108</sup> We considered these comments in connection with adopting Regulation SHO.<sup>109</sup>

## **VI. Paperwork Reduction Act Analysis**

### **A. Rule 3a51-1 Analysis**

In proposing the amendments to Rule 3a51-1, we noted that the rule does not impose any “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”).<sup>110</sup> Similarly, the amendments to Rule 15g-100 do not impose any “collection of information” requirements with the meaning of the PRA.

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

In proposing these amendments to the penny stock rules, we noted that certain provisions of the amendments to Rules 15g-2 and 15g-9 that we are adopting contain “collection of information” requirements within the meaning of the PRA.<sup>111</sup> The title for the collection of information under current Rule 15g-2, “Risk Disclosure Document Relating To the Penny Stock Market,” 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-

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<sup>108</sup> See letter from William A. Dedrick, to Jonathan G. Katz, Secretary, SEC (Jan. 19, 2004) and letter from Richard W. Treharne, IV, to Jonathan G. Katz, Secretary, SEC (Feb. 25, 2004).

<sup>109</sup> See Exchange Act Rel. No. 50103 (Jul. 28, 2004), 69 FR 48008 (Aug. 6, 2004).

<sup>110</sup> See Exchange Act Rel. No. 49037, at section VIII. See also 44 U.S.C. 3501, *et seq.*

<sup>111</sup> *Id.*

Priced Securities,” which the Commission is amending, contains a currently approved collection of information under OMB control number 3235-0385.

In the proposing release, we solicited comment on the collection of information requirements and submitted these requirements to the Office of Management and Budget (“OMB”) for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. OMB asked that we resubmit the requirements when the Commission adopted the rule amendments. The information received by a broker-dealer pursuant to Rules 15g-2 and 15g-9 is mandatory. An agency may not sponsor, conduct, or require response to an information collection, unless a currently valid OMB control number is displayed. The information received by a broker-dealer pursuant to Rules 15g-2 and 15g-9 is also governed by Regulation S-P<sup>112</sup> and the internal policies of the broker-dealer regarding confidentiality. In addition, the Commission or an SRO may review the information during the course of an examination.

We received eleven comments regarding the proposed amendments to Rules 15g-2 and 15g-9. None of the commenters addressed the PRA analysis of the proposed amendments, or any of the PRA issues raised by these amendments.

1. Summary of Collection of Information

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

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<sup>112</sup> See Title V of the Gramm-Leach-Bliley Act, Pub. L. 106-102, 113 Stat. 1338 (1999) (codified at 15 U.S.C. 6801 *et seq.*) (“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).

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 easily accessible place.<sup>113</sup>

The amendments that the Commission is adopting do not change the substance of the collection of information required by Rule 15g-2. The penny stock disclosure document will 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 will still have to be received by the broker-dealer and maintained in its records for the required period of time.

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.

As with the amendments to Rule 15g-2, the amendments to Rule 15g-9 that we are adopting do not change the substance of the collection of information required by the rule. Broker-dealers will continue to be required to provide suitability determinations to their customers and receive a signed copy of that document prior to effecting non-exempted transactions in penny stocks.

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<sup>113</sup> See 17 CFR 240.15g-2(c) (citing to 17 CFR 240.17a-4(b)).

The amendments to Rules 15-2 and Rule 15-9 respond to advances in technology and legislative developments governing the expanded use of electronic communications. They are designed to maintain investor protections regardless of whether broker-dealers that are subject to the penny stock rules use paper copies or electronic communications to obtain the required documents and signatures required by Rules 15g-2 and 15g-9.

2. Proposed Use of the Information

As the Commission discussed in detail when proposing these amendments, 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 rights and remedies available to investors under the federal securities laws. The requirement under 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 a customer 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 him or her.

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 amendments to Rules 15g-2 and 15g-9 will 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 investors communicating electronically with their broker-dealers with protections that are comparable to those that are available under the current penny stock rules, in light of the delays inherent in postal delivery.

As the Commission stated in proposing the amendments, the information collected and maintained by broker-dealers pursuant to Rules 15g-2 and 15g-9, including documents obtained by means of electronic communications, 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

Exchange Act Rules 15g-2 and 15g-9 only apply to broker-dealers effecting transactions in penny stocks that are not otherwise exempt. For example, Rule 15g-2

does do 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>114</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 that has not received more than 5 percent of its commissions and certain other revenue from transactions in penny stocks during each of the preceding three months.<sup>115</sup> Similarly, transactions with institutional or accredited investors are not subject to Rule 15g-2.<sup>116</sup> The rule also does not apply to transactions that meet the requirements of Regulation D under the Securities Act of 1933, or transactions with an issuer not involving a public offering.<sup>117</sup> A broker-dealer must provide one copy of the penny stock disclosure document to its customer, prior to the first penny stock transaction that is subject to the rule. Essentially, 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 transaction.

The same exemptions that apply to Rule 15g-2 also apply to Rule 15g-9,<sup>118</sup> along with one additional exemption. The provisions of Rule 15g-9 do not apply if the

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<sup>114</sup> Rule 15g-1(e) [17 CFR 240.15g-1(e)].

<sup>115</sup> Rule 15g-1(a) [17 CFR 240.15g-1(a)].

<sup>116</sup> See Rule 15g-1(b) [17 CFR 240.15g-1(b)].

<sup>117</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 percent of any class of 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)].

<sup>118</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 Rule 15g-9. 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.

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>119</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 Rule 15g-9, the broker-dealer may have to obtain more than a single transaction agreement under the rule, depending on the circumstances. When the Commission proposed these amendments, it estimated that 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>120</sup>

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

The amendments to Rules 15g-2 and 15g-9 are designed to adapt these two rules to an electronic or Internet-based environment. Under the 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. Except for the imposition of a formal waiting period, the rule amendments will

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<sup>119</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>120</sup> See Exchange Act Rel. No. 49037, 69 FR at 2544 n. 112. This estimate elicited no comments. We are, therefore, assuming that this estimate is accurate and we are using it to calculate the burden hour estimate required by the PRA.



not impose any significant additional recordkeeping, reporting, or other compliance requirement on broker-dealers.

The Commission noted when it proposed these amendments that a broker-dealer that becomes subject to the waiting period by complying with the rules' requirements through electronic communications may incur some additional costs associated with keeping track of the waiting period. Hence, the Commission recognized that under these 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. As the Commission stated when it proposed the amendments, we expected that the amendments would result only in a minimal increase in burden. Moreover, the Commission stated that it believed there should be no non-hour costs associated with the requirement. We received no comments regarding these statements in the proposing release. We, therefore, are utilizing them for the purposes of this PRA analysis.

The Commission estimated that there are approximately 240 broker-dealers that could potentially be subject to current Rule 15g-2, and that each one of these firms processes an average of three new customers for penny stocks per week. Thus, each respondent will process approximately 156 penny stock disclosure documents per year (three new customers x 52 weeks per year). If communications in tangible form alone are used to satisfy the requirements of 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 (156 penny stock disclosure documents x ten 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 x 156 responses for each x 2 minutes per response) or 1,248 hours, under current Rule 15g-2. Accordingly, the aggregate annual hour burden associated with Rule 15g-2 (that is, if all respondents continue to use tangible means of communication to comply with the rule) is approximately 7,488 hours (6,240 response hours + 1,248 recordkeeping hours). We received no comments regarding this estimate. We are therefore utilizing this estimate in connection with calculating the burden hours required to comply with Rule 15g-2.

a. Estimated Burden Hours

i. Burden Hours for Rule 15g-2

The Commission estimated that there are approximately 240 broker-dealers that could potentially be subject to current Rule 15g-2, and that each one of these firms processes an average of three new customers for penny stocks per week. Thus, we concluded that each respondent would process approximately 156 penny stock disclosure documents per year. If communications in tangible form alone are used to satisfy the requirements of 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, we determined that the respondents would incur an aggregate recordkeeping burden of 74,880 minutes (240 respondents x 156 responses for each x 2 minutes per response) or 1,248 hours, under Rule 15g-2. Accordingly, we stated when we proposed the amendments that the current aggregate annual hour burden associated with Rule 15g-2 (that is, assuming that all respondents provide tangible copies of the required documents) is approximately 7,488 hours (6,240 response hours + 1,248 recordkeeping hours). We received no comments regarding this estimate. We are therefore utilizing this estimate in connection with the calculation of the hour burden associated with Rule 15g-2, as amended.

We recognized, however, that the burden hours associated with Rule 15g-2 may be slightly reduced when 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 minutes estimated above, to provide the penny stock disclosure document by e-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 penny stock 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 customers x 8 minutes per respondent). Since there could be 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 available to us, we stated that we did not believe that recordkeeping burdens under Rule 15g-2 would increase if the required documents are sent or received by means of electronic communication, so the recordkeeping burden would remain at 1,248 hours. Thus, we concluded that if all broker-dealer respondents were to 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). Again, we received no comments regarding these calculations. Therefore, we are once again utilizing this estimate to calculate the burden hours required for compliance with Rule 15g-2, as amended.

In addition, we stated that, if the penny stock customer requests a paper copy of the information on the Commission's Web site regarding microcap securities, including penny stocks, from his or her broker-dealer, we estimated 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 estimated that, at most, a quarter of customers who are required to receive the Rule 15g-2 disclosure document will request that their broker-dealer provide them with the

additional microcap and penny stock information posted on the Commission's Web site. Thus, each broker-dealer 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 x 39 requests per respondent). Since there are 240 respondents, we determined that the estimated annual burden is 18,720 minutes (78 minutes per each of the 240 respondents) or 312 hours. We received no comments regarding this estimate. We are therefore utilizing it in connection with calculating the hour burden associated with Rule 15g-2, as amended.

We acknowledged that we have no way of knowing how many broker-dealers and customers will choose to communicate electronically. We assumed, however, that 50 percent of respondents would continue to provide documents and obtain signatures in tangible form and 50 percent would choose to communicate electronically to satisfy 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 x 0.50 of the respondents = 3,744 hours) + (aggregate burden hours for electronically signed and transmitted documents x 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)). These estimates were described in the proposing release and elicited no comments. We are, therefore, utilizing them in calculating the hour burdens required for compliance with Rule 15g-2, as amended.

ii. Burden Hours for Rule 15g-9

Likewise, we used the estimate of approximately 240 broker-dealers in our analysis of Rule 15g-9. As with our Rule 15g-2 burden hour analysis, we first used the

current burden hour analysis that assumes that only tangible means of communication are used to satisfy the rule's requirements. Next, we determined burden hours assuming that only electronic means of communication were used by broker-dealers and their customers. Finally, we assumed that half of the time communications in tangible form were used, and half of the time electronic means of communication were used. We received no comments regarding any estimates or calculations used in the analysis of the burden hours of Rule 15g-9 set forth in the proposing release.

Recognizing at the outset that although the burden of Rule 15g-9 on a respondent varies depending on the frequency with which new customers are solicited, we estimated that firms process an average of three new customers for penny stocks per week. We again concluded that each respondent would process approximately 156 new customer suitability determinations per year. We also estimated that a broker-dealer would expend approximately one-half hour per new customer in obtaining, reviewing, and processing (including transmitting to the customer) the information required by Rule 15g-9, and each respondent would consequently spend 78 hours annually (156 customers x .5 hours) obtaining the information required in the rule. We determined, based on the estimate of 240 broker-dealer respondents, that the current annual burden of Rule 15g-9 is 18,720 hours (240 respondents x 78 hours). We received no comments regarding this estimate. We are therefore utilizing it in connection with the calculation of the burden hours of the Rule 15g-9, as amended.

In addition, as with Rule 15g-2, we estimated that if tangible communications alone are used to transmit the documents required by Rule 15g-9, each customer should take: (1) no more than eight minutes to review, sign and return the suitability

determination document; and (2) no more than two minutes to either read and return or produce the customer agreement for 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, we stated that 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, we concluded that 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. We received no comments regarding this estimate. We are therefore utilizing it in connection with calculating the hour burdens required for compliance with Rule 15g-9.

In addition, we estimated that, if tangible means of communications alone are used, broker-dealers could incur a recordkeeping burden under Rule 15g-9 of approximately two minutes per response. Since there are approximately 240 broker-dealer respondents and each respondent would have approximately 156 responses annually, we stated that respondents would incur an aggregate recordkeeping burden of 74,880 minutes (240 respondents x 156 responses x 2 minutes per response), or 1,248 hours. Accordingly, we determined that the 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). We received no comments regarding these estimates. We are, therefore, utilizing them in calculating the hour burdens associated with Rule 15g-9, as amended.

We recognized that under the amendments to Rule 15g-9, the burden hours 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 minutes estimated above, to provide the transaction agreement by e-mail rather than regular mail). We stated that 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 x 9 minutes for each customer). Since there are 240 respondents, we estimated that the annual customer respondent burden, if electronic communications were used by all customers, would be approximately 336,960 minutes (240 respondents x 1,404 minutes per each respondent), or 5,616 hours. We also stated that we did 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 stated that we did not believe that, based on information currently available to us, recordkeeping burdens under Rule 15g-9 would change where the required documents were sent or received through means of electronic communication. Thus, we determined that 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 received no comments regarding these estimates. We are, therefore, utilizing them in our calculations of the burden hours imposed by Rule 15g-9, as amended.

We stated that we cannot estimate how many broker-dealers and customers will choose to communicate electronically. We stated that if we assume that 50 percent of



respondents would continue to provide documents and obtain signatures in tangible form, and 50 percent 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 x 0.50 of the respondents = 13,104 hours) + (25,584 aggregate burden hours for electronically signed and transmitted documents x 0.50 of the respondents = 12,792 hours)). We received no comments regarding these estimates and are, therefore, utilizing them to calculate the hour burden associated with Rule 15g-9.

iii. Aggregate Burden Hours for the Rule Amendments

When we proposed these rule amendments, we concluded that 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. We also concluded that 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 amendments as they were proposed, the total aggregate burden hours for complying with the requirements of Rules 15g-2 and 15g-9, in light of the available means of communication, would be 33,072 hours (7,176 hours + 25,896 hours). We received no comments regarding these estimates. We are, therefore, utilizing them in calculating the hour burdens associated Rules 15g-2 and 15g-9, as amended.

b. Estimate of Total Annualized Paperwork Cost Burden

i. Cost Burden of Rule 15g-2

Assuming that all communications required by Rule 15g-2 are complied with in tangible form, the paperwork costs of the signature and document requirements of Rule

15g-2 would include the costs of mailing the Schedule 15G penny stock disclosure document to the customer and providing a means by which to return the signed document (such as by return postage pre-paid envelopes). Postage costs (at \$0.37 each way or \$0.74 for both the outgoing and prepaid incoming documents) related to providing the Schedule 15G penny stock disclosure document and receiving the signed copy from the customer, as required by the rule, would be approximately \$27,706 (240 respondents x 156 new customers annually x \$0.74 for each document). We estimated that the broker-dealer time required to send the document to a customer would be an average compensation rate of \$24.10 per hour.<sup>121</sup> A broker-dealer's copying, sending, and recordkeeping hour burden under the rule, as noted above, is four minutes (1/15<sup>th</sup> of an hour). Broker-dealer time would therefore cost approximately \$1.61 for each Schedule 15G provided to its customer under the rule. We concluded that the total paperwork cost burden for broker-dealer time to comply with Rule 15g-2 would be approximately \$60,278 (240 respondents x 156 new customers annually x \$1.61 for each document). Thus, if the mail was used for all such documents, we estimated that the total paperwork annual cost burden to the industry to comply with Rule 15g-2 would be approximately \$87,984 (\$27,706 for postage + \$60,278 for staff time). These estimates elicited no comments and we are, therefore, utilizing them in calculating the cost burden of Rule 15g-2, as amended.

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<sup>121</sup> We based our estimate on the following information. 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. See Exchange Act Rel. No. 49037, 69 FR at 2546 n. 114. We used the same rate to estimate recordkeeping staff costs for compliance with Rule 15g-9.

When we proposed the amendments, we recognized that the electronic communication of the Schedule 15G penny stock disclosure document would reduce the costs of compliance with Rule 15g-2. There would be no postage costs for electronically transmitted documents, and broker-dealer time for e-mailing the disclosure document to the customer may be reduced (e.g., the broker-dealer respondent may take only one minute, instead of the estimated burden of two minutes, to provide the penny stock disclosure document by e-mail to its customer). Recordkeeping costs would likely remain the same. We stated that if all of the respondents estimated above send the Schedule 15G penny stock disclosure document 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 x 156 responses x 3 minutes for each response) or 1,872 hours. We determined that, at a broker-dealer time rate of \$24.10 per hour, total staff costs for compliance with the rule if all communication is electronic would be \$45,115 (1,872 hours x \$24.10/hour). Thus, we concluded that 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). We received no comments regarding these estimates. We are, therefore, utilizing them in calculating the cost burden of Rule 15g-2, as amended.

We stated that the broker-dealer respondent would incur additional postage costs under the proposed amendments to Rules 15g-2 and 15g-9 when its 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 concluded that such a request

would be made, at most, in only a quarter of first-time penny stock transactions. Because there will be no return postage, each such request would result in a postage cost to the broker-dealer of \$0.37. Thus, we determined that the aggregate annual postage cost for mailing documents containing the additional information will be \$3,463 (240 respondents x 39 new customers annually x \$0.37). We received no comments regarding this estimate. We are, therefore, utilizing it to calculate the cost burden associated with Rule 15g-2, as amended.

In proposing the rule amendments, we acknowledged that we could not estimate how many broker-dealers and customers would choose to communicate electronically. We stated that if we assumed that 50 percent of broker-dealer respondents would continue to provide documents and obtain signatures in tangible form, and 50 percent of the customer respondents would choose to communicate electronically in satisfaction of the requirements of the rule, 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 x 0.50 of the respondents = \$43,992) + (\$45,115 aggregate cost burden for electronically signed and transmitted documents x 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)). We received no comments regarding the estimated cost burden of Rule 15g-2. We are, therefore, utilizing it in calculating the cost burden of Rule 15g-2, as amended.

ii. Cost Burden of Rule 15g-9

In proposing the amendments to Rules 15g-2 and 15g-9, we stated that we believe, generally, that 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 a customer. The Commission estimated that the average blended cost to the broker-dealer respondent for these personnel is \$75 per hour,<sup>122</sup> and the total annualized cost for compliance with this portion of the current rule is \$1,404,000 (18,720 hours x \$75 per hour personnel costs). We received no comments regarding these estimates. We are, therefore, utilizing them when calculating the cost burden of Rule 15g-9, as amended.

In addition to the costs of preparing the suitability determination under the rule, broker-dealer respondents also incur the cost associated with delivering the suitability statement to its customers, and of receiving both the signed acknowledgement, as well as the transaction agreement required by the rule (such as by return postage pre-paid envelopes). Postage costs (at \$0.37 for each or \$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 x 156 new customers annually x \$0.74 for each document).

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<sup>122</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 and hour. See Report On Management & Professional Earnings In The Securities Industry 2002. See also Exchange Act Rel No. 49037, 69 FR at 2546 n. 115.

We received no comments regarding these estimates. We are, therefore, utilizing them in calculating the final cost burden of Rule 15g-9, as amended.

In addition, we estimated that broker-dealer respondents would 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 Rule 15g-9 is 1,248 hours. Using a \$24.10 per hour average for recordkeeping staff time, the aggregate annual recordkeeping broker-dealer burden associated with Rule 15g-9 is \$30,077 (1,248 hours x \$24.10 per hour staff costs). Thus, if only communications in tangible form are used, the total aggregate annual cost burden to broker-dealer respondent under Rule 15g-9 is approximately \$1,461,783 (\$1,404,000 staff costs to prepare and send the suitability statement and the transaction agreement + \$27,706 postage + \$30,077 record keeping personnel costs). We received no comments regarding these estimates. We are, therefore, utilizing them in our calculation of the final cost burden of Rule 15g-9, as amended.

In the proposing release, we acknowledged that the cost burden under Rule 15g-9 may be reduced when 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 postage for delivery of the required documents would be \$0.00. We stated that we did not believe that the personnel cost burden on broker-dealer respondents and their personnel in obtaining, reviewing, and processing the suitability determination would change through use of electronic communications. In addition, we stated that we did not believe that, based on the

information available, recordkeeping burdens under Rule 15g-9 would change if the required documents were sent or received through means of electronic communication. Thus, we concluded that 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 record keeping personnel costs). We received no comments regarding these estimates. We are, therefore, utilizing them in our calculation of the cost burden of Rule 15g-9, as amended.

We acknowledged that we cannot estimate how many broker-dealers and customers would choose to communicate electronically. We stated that if we assume that 50 percent of respondents would continue to provide documents and obtain signatures in tangible form, and 50 percent 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 x 0.50 of the respondents = \$730,891) + (\$1,434,077 aggregate cost burden for electronically signed and transmitted documents x 0.50 of the respondents = \$717,039)). We received no comments regarding the estimated cost burden of Rule 15g-9. We are therefore utilizing this estimate in our final calculation of the cost burden associated with Rule 15g-9, as amended.

iii. Aggregate Cost Burden for the Rule Amendments

When we proposed the amendments, we stated that 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. We also stated that 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, we concluded that 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 received no comments regarding these estimates.

We noted at that time that the amendments may not significantly alter the current burden on broker-dealers engaged in penny stock transactions because 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.

We also noted that, for purposes of the PRA, the annual reporting and recordkeeping cost burden must exclude the cost of hour burden.<sup>123</sup> Therefore, we determined that 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 broker-dealer staff. We again assumed that 50 percent of respondents would use electronic means to comply with the amended rule, and 50 percent of respondents would use traditional means of communication. Hence, we determined that

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<sup>123</sup> See OMB Form 83-1, Instructions to Item 14.



the estimated cost burden for compliance with amended Rule 15g-2 would be approximately \$17,316 ((\$27,706 for postage x .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 x .50 of respondents). Although we solicited comments, we received no response from commenters regarding these estimates. We are, therefore, utilizing them in calculating the aggregate paperwork cost burden for amended Rules 15g-2 and 15g-9.

iv. General Information about the Collection of Information

We pointed out in the proposing release that any collection of information pursuant to Rules 15g-2 and 15g-9 is mandatory. We also stated that for all non-exempt transactions in penny stocks, broker-dealers must provide the Schedule 15G 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>124</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

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<sup>124</sup> See Rule 15g-2(b) and Rule 17a-4 [17 CFR 240.17a-4].

the federal securities laws and applicable SRO rules. The Commission and SROs would obtain possession of the information only upon request.

## **VII. Costs and Benefits of Rule Amendments**

We solicited comments relating to the costs and benefits associated with the proposed rule amendments. We explicitly requested that commenters provide supporting empirical data for any positions advanced. We particularly sought comment on whether, and to what extent, the rule amendments would impose costs in addition to those already imposed under the current rules.

Only one commenter directly addressed the costs and benefits of these rule amendments,<sup>125</sup> stating that he believed costs associated with the rule amendments would be minimal. Another commenter complained about the costs of the two-day waiting period imposed by the proposed amendments to Rules 15g-2 and 15g-9.<sup>126</sup> We discuss these comments below in section B.

The Commission is sensitive to the costs and benefits that result from its rules. We have identified certain costs and benefits associated with the rule amendments.

### **A. Rule 3a51-1**

In proposing the amendments to Rule 3a51-1, we stated that the costs of the proposed amendments should be minimal. As noted above, the only comment we received on this issue supported this view. We believe that the amendments will have only a limited impact on the penny stock market. For example, the amendments to the

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<sup>125</sup> See Stoecklein letter, supra at n. 40 (“As we understand your proposals and the cost analysis, we believe that the costs associated with the proposed amendments would be minimal. In addition, the electronic transmission and storage of the information would minimize the burden further. We are assuming that the maintenance of these documents could, and most likely would occur, electronically.”).

<sup>126</sup> See Beloyan letter, supra at n. 69.

current exclusions from the definition of penny stock for reported securities, and for certain other exchange-registered securities, require that these securities also satisfy one of the following new standards. First, an exchange-registered security could qualify for an exclusion 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 for an exclusion 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 on the Nasdaq SmallCap Market. As we noted in proposing these amendments, they are wholly prospective and are not intended to change the status quo. Securities currently listed and traded on national securities exchanges and on Nasdaq would be “grandfathered.” Moreover, we noted that all national securities exchanges have initial listing and continued listing standards,<sup>127</sup> which have been reviewed and approved by the Commission.<sup>128</sup> Any cost associated with the new rule amendments should be fairly minimal 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 Nasdaq SmallCap securities, should meet the new listing standards.

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<sup>127</sup> See, e.g., NASD Rule 4310.

<sup>128</sup> Section 19(b)(1) of the Exchange Act [15 U.S.C. 78s(b)(1)].

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

We also noted that the amendments will reduce duplicative regulation with respect to security futures products and will also enhance legal certainty by deleting outdated and possibly confusing sections of the rule. We concluded that given the incremental change to the costs associated with the rule, the benefits of the amendments to Rule 3a51-1 will justify the costs. We received no comment or information that has caused us to alter this conclusion.

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

In proposing the amendments to Rules 15g-2 and 15g-9, we stated that we did not expect to impose any new regulatory costs on broker-dealers. One commenter disagreed, expressing concern that imposing a uniform two-day waiting period on those broker-dealers making markets in penny stocks, and soliciting unsophisticated investors to engage in penny stock transactions, impose a cost on full service broker-dealers.<sup>129</sup> In

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<sup>129</sup> See Beloyan letter, supra at n. 69 (“As a full service broker/dealer we have to compete with the internet discount broker dealers, which most investors have. If I recommend something to my client, then get an order and have to wait 2 days, it is not feasible as it first of all is not giving the client a best execution. I can see it now, you call a client to buy something that is defined as a penny stock and get an order for \$5000.00 and then tell the client he has to wait 2 business days before you can buy it for him, and the stock goes up to where his \$5000.00 would be worth \$7,000.00 to \$10,000.00 and now the client is upset and never does business with you again, or he goes to his internet account and uses your idea to buy the stock as an unsolicited order and gets immediate execution. This takes away a full service broker dealer right [sic] to recommend and find small companies that could prove very lucrative as an investment. In addition the client could even start a lawsuit/arbitration against the broker/dealer.”).

contrast, another commenter supported our analysis regarding the costs of these amendments, stating that the electronic transmission and storage of the documents required by these rules would reduce the costs of complying with them.<sup>130</sup>

We disagree that the imposition of a uniform, two-day waiting period will impose additional costs on broker-dealers. The 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 this uniform waiting period simply preserves the status quo by replicating the time it would take for postal delivery of the documents required by Rules 15g-2 and 15g-9, we do not believe that the rule amendments would produce any significant new costs to broker-dealers.

This commenter also points out that there 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 application of the requirements in Rule 15g-2 and 15g-9 is limited to broker-dealers that actively solicit transactions in penny stocks. 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 the rule. On the other hand,

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<sup>130</sup> See Stoecklein letter, supra at n. 40.

providing and receiving the required customer protection documents under the rules through electronic means may save those penny stock broker-dealers subject to the rules the out-of-pocket costs of postage or other delivery methods.

We also observed that failure to adopt rule amendments that address electronic communications could 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. Any costs associated with the amendments to the Rules 15g-2 and 15g-9 are justified by the benefits of reducing fraud.<sup>131</sup> In light of the fact that the only comment we received on this issue supports the analysis set forth in the proposing release, our analysis remains unchanged.

### **C. Rule 15g-100**

In proposing the amendments to Rule 15g-100, we stated the costs of the proposed amendments should be minimal. The changes will have only a limited impact on those broker-dealers making markets in penny stocks because of the narrow circumstances in which the penny stock disclosure document is required. The revisions to this document will not affect the frequency with which it is sent to customers. In addition, these changes should help reduce fraud by making the document more accessible and understandable to investors.

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<sup>131</sup> When it adopted Rule 15g-9, the Commission stated, “[W]e 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.

We requested comment on the costs and benefits of these changes to the penny stock disclosure document and the instructions to it set forth in Schedule 15G. We received no comments regarding the costs and/or benefits of these amendments.

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

We solicited comments on the effect of the proposed amendments on competition, efficiency, and capital formation. For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996,<sup>132</sup> the Commission also requested information regarding the potential effect of the proposals on the U.S. economy on an annual basis. Commenters were invited to provide empirical data to support their views.

We received two comments regarding these issues.<sup>133</sup> One commenter concurred with our analysis that the amendments will promote efficiency, competition, and capital formation by providing general protections for investors and by increasing investor confidence and involvement in the securities of small businesses.<sup>134</sup> One market commented that the proposed amendments to Rule 3a51-1 would “thwart” the stated goals of Congress and the Commission to foster competition since some markets would have a built-in advantage memorialized in Commission regulation.<sup>135</sup> Another commenter indicated that the proposed amendments to Rules 15g-2 and 15g-9 would burden full-service broker-dealers in competing with Internet broker-dealers.<sup>136</sup>

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<sup>132</sup> Pub. L. 104-21, Title II, 110 Stat. 857 (1996).

<sup>133</sup> See Stoecklein letter, supra at n. 40.

<sup>134</sup> Id. (“In conclusion, we concur with the staff’s opinion that the proposed amendments 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>135</sup> See Nasdaq letter, supra at n. 16.

<sup>136</sup> See Beloyan letter, supra at n. 69.

Section 3(f) of the Exchange Act requires the Commission, when engaging in rulemaking, to consider or determine whether an action is necessary or appropriate in the public interest, and whether the action would promote efficiency, competition and capital formation.<sup>137</sup> Section 23(a)(2) of the Exchange Act requires the Commission to consider the anticompetitive effects of any rules that we adopt under the Exchange Act.<sup>138</sup> Section 23(a)(2) further prohibits the Commission 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 amendments to Rules 3a51-1, 15g-2 and 15g-9, and 15g-100 are consistent with the public interest and will promote efficiency, competition, and capital formation by providing greater protections for investors, thus increasing investor confidence and investment in the securities of small businesses.<sup>139</sup>

We do not believe that the amendments that the Commission is adopting 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. We disagree that the amendments to Rule 3a51-1 could harm competition between markets. We continue to view these amendments as essentially neutral. They should preserve – not change – the status quo with respect to the registered national securities exchanges and Nasdaq. The amendments are not designed to change the listing standards of Nasdaq

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<sup>137</sup> 15 U.S.C. 78c(f).

<sup>138</sup> 15 U.S.C. 78w(a)(2).

<sup>139</sup> See Exchange Act Rel. No. 30608, 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.”).



and “grandfathered” exchanges, and should not encourage or facilitate regulatory arbitrage.

While the amendments conceivably could impose some competitive burdens on wholly new markets, wholly new facilities or “junior tiers” of markets, such potential competitive burdens are more than outweighed by the benefits of the proposed amendments. Amendments to Rule 3a51-1 would prevent those 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 will continue to receive the increased protection that Congress intended they receive under the Penny Stock Reform Act. In addition, the amendments to Rule 3a51-1 will promote capital formation by encouraging investment because of increased investor confidence and will apply equally to all broker-dealers making markets in penny stocks.

The other changes to Rule 3a51-1 will encourage efficiency by updating the definition of penny stock. For example, Rule 3a51-1 will exclude security futures products from this definition.

With regard to the amendment to Rules 15g-2 and 15-9, we do not believe that the explicit waiting periods imposed under these amendments will increase the existing burdens under the penny stock rules. Indeed, with respect to communications sent through the mail, the rules already effectively impose a similar waiting period. As discussed above, 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 amendments will ensure that all investors in

penny stocks, whether they communicate through traditional means or electronically, will retain the opportunity for careful consideration.

We do not believe that the amendments to Rules 15g-2 and 15g-9 will adversely affect capital formation. One commenter indicated that the amendments may hinder capital formation.<sup>140</sup> However, as the Commission stated when it first adopted the penny stock rules and when it proposed the amendments, 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 rule amendments will continue to benefit legitimate penny stock issuers and the broker-dealers making markets in those issuers' securities. Moreover, because these rule amendments will 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 will 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 will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. As noted above, one commenter asserted that the proposed amendments to these rules would harm competition between full service broker-dealers and Internet-based broker-dealers.<sup>141</sup> We disagree. The amendments to Rules 15g-2 and 15g-9 merely impose an

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<sup>140</sup> See Beloyan letter, supra at n. 69 (“How can venture capital and new ideas with small public companies exist and grow with more restrictions? Doesn’t putting more government into what is already here, which by the way seems to be working fine, significantly curbed [sic] growth in our economy?”).

<sup>141</sup> Id.

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 this uniform waiting period simply preserves the status quo by replicating the time it would take for postal delivery of the required disclosure documents, we do not believe that the rule amendments will impose any additional competitive burdens on penny stock brokers and dealers. We believe the amendments will instead promote competition by redesigning this necessary regulatory scheme to permit broker-dealers and investors to take advantage of rapidly evolving technology.

Finally, we believe that the changes we are proposing to the penny stock disclosure document, as set forth in Schedule 15G, will not impose any burden on competition. On the contrary, by streamlining the document, making it more readable, and generally adapting it to electronic media, the penny stock disclosure document will promote efficiency, competition, and capital formation.

## **IX. Final Regulatory Flexibility Analysis**

The Commission has certified, pursuant to 5 U.S.C. 605(b) that the amendments to Rules 3a51-1, 15g-2 and 15g-9, and 15g-100 will not have a significant economic impact on a substantial number of small entities. This certification was incorporated into the release proposing these amendments. The Commission received no comments about the impact on small entities or the Regulatory Flexibility Act certification.

**X. Statutory Authority**

The Commission is adopting 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(a)(51)(B), 3(b), 15(c), 15(g) and 23(a) of the Exchange Act [15 U.S.C. 78c(a)(51)(B), 78c(b), 78o(c), 78o(g), and 78w(a)].

**Text of 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 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, 78e, 78f, 78g, 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, 80b-11, and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

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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 § 240.11Aa3-1(a), 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 (§ 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 paragraph (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 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 paragraph (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 paragraph (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) of this section; and

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

\* \* \* \* \*

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

(i) 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;

(ii) 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

(iii) The security satisfies the requirements of paragraph (a)(1) or (a)(2) of this section;

(2) 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 (15 U.S.C. 78o(b)(6));

(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; or

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3. Section 240.15g-2 is amended by:
- (a) Revising the section heading;
  - (b) Revising paragraph (a);
  - (c) Redesignating paragraph (b) as paragraph (c);
  - (d) Adding new paragraph (b); and
  - (e) Adding paragraph (d).

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, § 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.

\* \* \* \* \*

(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)(2)(ii)(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 and easy to read. 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.nasd.com](http://www.nasd.com). You can also get additional information from your state securities official. The North American Securities Administrators Association, Inc. 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).

By the Commission.

J. Lynn Taylor  
Assistant Secretary

Dated: July 7, 2005