NASD

Notice To Members

National Association of Securities Dealers, Inc. July 1992

Number 92-36

Suggested Routing:*

✓ Senior Management	Internal Audit	Operations	Syndicate
Corporate Finance	✓ Legal & Compliance	Options	Systems
Government Securities	✓ Municipal	Registration	Trading
Institutional	Mutual Fund	Research	Training

*These are suggested departments only. Others may be appropriate for your firm.

MAIL VOTE

Subject: Proposed Amendment to Article III, Section 35 of the NASD's Rules of Fair Practice And Section 8 of the NASD's Government Securities Rules to Require Members to Prefile Advertisements for Collateralized Mortgage Obligations; Last Voting Date: August 21, 1992

EXECUTIVE SUMMARY

The NASD invites members to vote on proposed amendments to Article III, Section 35 of the NASD's Rules of Fair Practice and Section 8 of the NASD's Government Securities Rules to require members to file advertisements pertaining to corporate and government collateralized mortgage obligations (CMOs) for review and approval by the NASD's Advertising Department prior to use or publication. The amendments would take effect immediately on approval by the Securities and Exchange Commission (SEC). However, the rule will be temporary, remaining in effect for one year. The Association will evaluate the efficacy of the rule near the end of the first year and determine whether to extend it permanently. The last voting date is August 21, 1992.

The text of the proposed rule change follows this Notice.

BACKGROUND

The NASD is proposing to amend Article III, Section 35 of the NASD's Rules of Fair Practice and Section 8 of the NASD's Government Securities Rules to require members to file advertisements concerning collateralized mortgage obligations (CMOs) issued by a corporation or an agency of the United States government with the Association prior to use. The requirement would be temporary, lasting for one year. Near the end of the first year, the Association will evaluate the efficacy of the rule and determine whether to continue or eliminate it.

The proposed amendments resulted from the NASD's increasing concern about misleading advertisements for CMOs and an increase in the number of complaints associated with advertisements for CMOs. The NASD believes that CMOs are extremely complex and require full and fair disclosure to assist the investor in understanding them. CMO advertisements generally are brief and emphasize high yields, safety, government guarantees (where applicable), and liquidity. The NASD has found, however, that it is difficult to distinguish

between CMOs based on the content of such advertisements. Even though two CMOs have the same underlying collateral, they may differ substantially in their prepayment predictability or volatility. In particular, the terms "interest only" or "principal only" are generally inadequately explained.

As a result of these concerns, the NASD issued *Notice to Members 92-27* (May 1992) detailing the problems relating to CMO advertising and recommending that members' CMO advertisements comply with certain standards set forth in the Notice. For example, the NASD believes that an advertisement including the "yield" of a CMO is misleading without disclosure of the prepayment assumption used to calculate the yield and disclosure that the anticipated yield and average life of the security will fluctuate depending on the actual prepayment experience and current interest rates.

The NASD also recommended in *Notice to Members 92-27* that CMO advertisements not contain comparisons between CMOs and any other investment vehicles. The NASD is particularly concerned that advertising CMOs as alternatives to certificates of deposit (CDs) falsely implies that CMOs offer the same level of safety and guarantee of interest and principal as do CDs.

The NASD believes that CMO advertisements should be subject to preuse filing to provide NASD staff an opportunity to comment on the fairness and reasonableness of such advertisements prior to use, and to permit potentially misleading advertisements to be identified and withheld from publication. At present, advertisements concerning government securities must be filed with the NASD within 10 days of first use or publication. In addition, advertisements and sales literature concerning registered investment companies and direct participation programs must be filed within 10 days of first use. Advertising and sales literature pertaining to options must be approved in advance of its use or publication.

The NASD believes that a preuse filing requirement for CMO advertisements, similar to the requirement for options advertising, is appropriate, provided that the proposed rule would be effective for one year only. Toward the end of the year, the effect of the rule will be evaluated to determine if sufficient improvements in CMO advertising have been achieved and whether the rule should be repealed or adopted permanently.

DESCRIPTION OF PROPOSED AMENDMENT

The NASD is proposing to amend Article III, Section 35 of the NASD's Rules of Fair Practice to consolidate the current filing requirements with respect to registered investment companies and public direct participation programs set forth in Subsections (c)(1) and (2), respectively, into new Subsection (c)(1). The Association is not proposing to change the requirements regarding registered investment companies and public direct participation programs.

The suggested new requirement with respect to CMO advertising is set forth in proposed new Subsection (c)(2) of Section 35. The new provision would require that all advertisements concerning corporate CMOs be filed with the Association's Advertising Department at least 10 days prior to first use unless the Department permits a shorter period in particular circumstances. The advertisement must be approved prior to use and, if changed or expressly disapproved by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made.

In the event of disapproval by the Association, the advertisement must be refiled for and have received Association approval prior to publication or circulation. The proposed new provision is similar to that previously adopted with respect to options advertisements and is contained in Subsection (c)(1) to Article III, Section 35A of the Rules of Fair Practice.

A similar provision is proposed to be adopted as new Subsection 8(c)(1)(B) to the NASD Government Securities Rules with respect to CMOs issued by an agency of the United States government. A technical amendment is also proposed to delete current Subsection 8(c)(2)(B), which applied to the filing of advertisements concerning government securities during the first year of the operation of the Government Securities Rules that were adopted by the NASD in 1989.

REQUEST FOR VOTE

The NASD Board of Governors believes that the proposed amendments to the Rules of Fair Practice and Government Securities Rules are important to prevent misleading advertising and to protect investors with respect to the advertising of CMOs. The Board considers the proposed amendment necessary and appropriate and recommends

that members vote their approval. The text of the proposed amendments that require member vote is below.

Please mark the attached ballot according to your convictions and mail it in the enclosed, stamped envelope to The Corporation Trust Company. Ballots must be postmarked **no later than August 21, 1992.** The amendment will not be effective until it is filed with and approved by the SEC.

Questions concerning this Notice should be directed to R. Clark Hooper, Director, Advertising, at (202) 728-8330, or Elliott R. Curzon, Office of General Counsel, at (202) 728-8451.

TEXT OF PROPOSED AMENDMENTS TO ARTICLE III, SECTION 35 OF THE RULES OF FAIR PRACTICE AND SECTION 8 OF THE NASD's GOVERNMENT SECURITIES RULES

(**Note:** New text is underlined; deleted text is in brackets.)

RULES OF FAIR PRACTICE

Communications With the Public

Sec. 35.

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(c) Filing Requirements and Review Procedures

[(1) Advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) shall be filed with the Association's Advertising Department within 10 days of first use or publication by any member. Filing in advance of use is recommended. Members are not required to file advertising and sales literature which have previously been filed and which are used without change.]

[(2) Advertising and sales literature concerning public direct participation programs as defined in Article III, Section 34 of the Rules of Fair Practice shall be filed with the Association's Advertising Department for review within 10 days of first use or publication. Filing in advance of use is recommended. Members need not file for review advertising and sales literature which has been filed by the sponsor, general partner or underwriter of the program or by another member.]

(1) Advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) and public direct participation programs (as defined in Article III, Section 34 of the Rules of Fair Practice) shall be filed with the Association's Advertising Department within 10 days of first use or publication by any member. Filing in advance of use is recommended. Members are not required to file advertising and sales literature which has previously been filed and which is used without change, or which has been filed by the sponsor, general partner or underwriter of the program or by another member.

(2) Advertisements concerning collateralized mortgage obligations registered under the Securities Act of 1933 shall be filed with the Association's Advertising Department for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed or expressly disapproved by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made or, in the event of disapproval, until the advertisement has been refiled for, and has received, Association approval.

GOVERNMENT SECURITIES RULES

Communications With the Public

Sec. 8

* * * * *

(c) Filing Requirements and Review Procedures

(1) Members shall file advertisements for review with the Association's Advertising Department as follows:

(A) Advertisements concerning government securities (as defined in Section 3(a)(42) of the Securities Exchange Act of 1934) other than collateralized mortgage obligations shall be filed by members with the Association's Advertising Department for review within 10 days of first use or publication; and

(B) Advertisements concerning collateralized mortgage obligations shall be filed with the Association's Advertising Department for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed or expressly disapproved by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made or, in the

event of disapproval, until the advertisement has been refiled for, and has received, Association approval.

(2) [(A)] Each member of the Association that has not previously filed advertisements with the Association shall file its initial advertisement concerning government securities with the Association's Advertising Department at least 10 days prior to use and shall continue to file its advertisements concerning government securities at least 10 days prior to use for a period of one year.

[(B) Each member that, on the effective date of this section, had been filing advertisements with the Association for a period of less than one year shall continue to file its advertisements concerning government securities at least 10 days prior to use, until the completion of one year from the date the first advertisement was filed with the Association.]

NASD

Notice To Members

National Association of Securities Dealers, Inc. July 1992

Number 92-37

Suggested Routing:*

✓ Senior Management	✓ Internal Audit	__ Operations	__ Syndicate
__ Corporate Finance	✓ Legal & Compliance	__ Options	__ Systems
__ Government Securities	__ Municipal	__ Registration	__ Trading
__ Institutional	__ Mutual Fund	__ Research	__ Training

*These are suggested departments only. Others may be appropriate for your firm.

MAIL VOTE

Subject: Proposed Amendment to Article III, Section 21 of the Rules of Fair Practice to Require Predispute Arbitration Agreements to Include a Notice That Class-Action Matters May Not Be Arbitrated; Last Voting Date: August 21, 1992

EXECUTIVE SUMMARY

The NASD invites members to vote on a proposed amendment to Article III, Section 21 of the NASD Rules of Fair Practice to incorporate into predispute arbitration agreements a provision that will make class action disputes ineligible for submission to NASD arbitration. The amendment would take effect one year after Securities and Exchange Commission (SEC) approval. The last voting date is August 21, 1992. The text of the proposed amendment follows this Notice.

BACKGROUND AND DESCRIPTION OF PROPOSAL

The Securities Industry Conference on Arbitration (SICA) recently adopted a change to the Uniform Code of Arbitration to exclude class actions from arbitration proceedings conducted by the self-regulatory organizations that are members of SICA, including the NASD. This change resulted from the SEC's desire, articulated by former SEC Chairman David Ruder, that investors should have access to the courts in appropriate cases. The NASD's Code of Arbitration Procedure (Code) allows arbitrators and the Director of Arbitration to defer certain arbitration proceedings to the court system. However, the NASD determined that the treatment of class actions in the Code should be clarified.

This proposed amendment to Article III, Section 21 of the Rules of Fair Practice set forth below would do that by requiring predispute arbitration agreements to contain a statement to the effect that class actions may not be arbitrated. This provision would take effect one year after SEC approval, so members could have time to redraft and reprint their arbitration agreements. The text of a related amendment to the Code of Arbitration Procedure is included for purposes of information only as this amendment does not require member vote.

REQUEST FOR VOTE

The NASD Board of Governors (Board) believes that the proposal will clarify the existing policy of deferring class-action matters to the court system. The Board considers the proposed amendment necessary and appropriate and recommends that members vote their approval.

Please mark the attached ballot according to your convictions and mail it in the enclosed,

stamped envelope to The Corporation Trust Company. Ballots must be postmarked **no later than August 21, 1992.**

Direct questions concerning this Notice to Deborah Masucci, Vice President, Arbitration, at (212) 480-4881.

PROPOSED AMENDMENT TO ARTICLE III OF THE RULES OF FAIR PRACTICE REQUIRING MEMBER VOTE

(**Note:** New text is underlined; deleted text is in brackets.)

ARTICLE III

* * * * *

Books and Records

Sec. 21.

Requirements When Using Predispute Arbitration Agreements With Customers

(f)(1) through (4) unchanged.

(5) The requirements of [this subsection] subparagraphs (f)(1) through (4) shall apply only to new agreements signed by an existing or new customer of a member after September 7, 1989.

(6) All agreements shall include a statement that "No person shall bring a putative or certified class action to arbitration, nor seek to enforce any predispute arbitration agreement against any person who has initiated in court a putative class action; or who is a member of a putative class who has not opted out of the class with respect to any claims encompassed by the putative class action until: (i) the class certification is denied; or (ii) the class is decertified; or (iii) the customer is excluded from the class by the court. Such forbearance to enforce an agreement to arbitrate shall not constitute a waiver of any rights under this agreement except to the extent stated herein."

(7) The requirements of subparagraph (6) shall apply only to new agreements signed by an existing or new customer of a member after (one year from date of SEC approval).

PROPOSED AMENDMENTS TO THE CODE OF ARBITRATION PROCEDURE NOT REQUIRING MEMBER VOTE

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PART III — UNIFORM CODE OF ARBITRATION

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Required Submission

Sec. 12. (a), (b) and (c) Unchanged.

(d) Class Action Claims.

(1) A claim submitted as a class action shall not be eligible for arbitration under this Code at the Association.

(2) Any claim filed by a member or members of a putative or certified class action is also ineligible for arbitration at the Association if the claim is encompassed by a putative or certified class action filed in federal or state court, or is ordered by a court to an arbitral forum not sponsored by a self-regulatory organization for classwide arbitration. However, such claims shall be eligible for arbitration in accordance with Section 12(a) or pursuant to the parties' contractual agreement, if any, if a claimant demonstrates that it has elected not to participate in the putative or certified class action or, if applicable, has complied with any conditions for withdrawing from the class prescribed by the court.

Disputes concerning whether a particular claim is encompassed by a putative or certified class action shall be referred by the Director of Arbitration to a panel of arbitrators in accordance with Section 13 or Section 19 of the Code, as applicable. Either party may elect instead to petition the court with jurisdiction over the putative or certified class action to resolve such disputes. Any such petition to the court must be filed within ten business days of receipt of notice that the Director of Arbitration is referring the dispute to a panel of arbitrators.

(3) No member or associated person shall seek to enforce any agreement to arbitrate against a customer who has initiated in court a putative class action or is a member of a putative or certified class with respect to any claims encompassed by the class action unless and until: (A) the class certification is denied; (B) the class is decertified; (C) the customer is excluded from the class by the court; or (D) the customer elects not to participate in the putative or certified class action or, if applicable, has complied with any conditions for withdrawing from the class prescribed by the court.

(4) No member or associated person shall be deemed to have waived any of its rights under this Code or under any agreement to arbitrate to which it is party except to the extent stated in this paragraph.

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Notice To Members

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Number 92-38

Suggested Routing:*

✓ Senior Management	Internal Audit	✓ Operations	✓ Syndicate
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Government Securities	Municipal	Registration	✓ Trading
Institutional	Mutual Fund	Research	✓ Training

*These are suggested departments only. Others may be appropriate for your firm.

Subject: SEC Adoption of Penny-Stock Disclosure Rules Under the Securities Enforcement Remedies and Penny Stock Reform Act of 1990

EXECUTIVE SUMMARY

The Securities and Exchange Commission (SEC) recently adopted seven rules ("Rules") under the Securities Exchange Act of 1934 requiring broker/dealers engaging in certain recommended transactions with their customers in specified equity securities falling within the definition of "penny stock" (generally non-Nasdaq securities priced below $5 per share) to provide to those customers certain specified information.

Unless the transaction is exempt under the Rules, broker/dealers effecting customer transactions in such defined penny stocks are required to provide their customers with: (1) a risk disclosure document; (2) disclosure of current bid and ask quotations, if any; (3) disclosure of the compensation of the broker/dealer and its salesperson in the transaction; and (4) monthly account statements showing the market value of each penny stock held in the customer's account. These SEC Rules were adopted in April 1992 pursuant to the requirements of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("Penny Stock Act"). The penny-stock definition and exemptive provisions are currently effective. The requirement for the delivery of the risk disclosure document to the customer became effective July 15, 1992. The other disclosure requirements take effect January 1, 1993. (A *Federal Register* copy of the rules is attached to this Notice.)

I. DEFINITION OF PENNY STOCK

SEC Rule 3a51-1 defines the term "penny stock" as "any equity security" other than the following excluded securities:

A. "Reported securities" — those for which last-sale reports are collected and made available pursuant to an effective transaction reporting plan. Included are Nasdaq/NMS securities, securities listed on the New York Stock Exchange (NYSE) and the American Stock Exchange (Amex) (including securities listed on the Amex Emerging Company Marketplace), and securities meeting NYSE and Amex listing standards that are listed on other national stock exchanges.

B. Securities registered, or approved for registration upon notice of issuance, on a national secu-

rities exchange provided that 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 pursuant to the exchange's rules, and that the security is bought or sold in a transaction effected on or through the facilities of the exchange, or is part of the distribution of the security. Currently qualifying for this exclusion are equity securities listed on the NYSE, Amex, the Boston Stock Exchange, the Cincinnati Stock Exchange, the Midwest Stock Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange, and the Chicago Board Options Exchange.

C. Securities authorized or approved for authorization upon notice of issuance for quotation in the regular Nasdaq market (known as "Nasdaq Small-Cap Market"[SM]), provided that price and volume information about transactions in the security is reported on a current and continuing basis and made available to vendors pursuant to NASD rules. This exclusion for Nasdaq Small-Cap Issues was based in part on the recent commencement of last-sale price and volume reporting for those securities.

D. Securities priced at $5 per share or more, excluding any broker/dealer commission, commission equivalent, markup or markdown. The actual transaction price is used or, in the absence of a transaction, the price is the inside bid quotation for the security displayed on an automated interdealer quotation system having characteristics specified by the Exchange Act, including dissemination of last-sale information. (No such system currently exists.) If there is no inside bid quotation, the price will be determined by the average of three or more bid quotations by market makers in an interdealer quotation system, which includes the OTC Bulletin Board® and other quotation media of general circulation such as the "Pink Sheets."

E. Securities of an issuer having either:

1. More than $2 million of net tangible assets (total assets less intangible assets less liabilities), if the issuer has operated continuously for at least three years, or at least $5 million, if the issuer has operated continuously for less than three years; or
2. Average revenue of at least $6 million for the last three years.

F. Securities issued by an investment company registered under the Investment Company Act of 1940; or

G. Put and call options issued by the Options Clearing Corporation.

II. TRANSACTION EXEMPTIONS FROM THE DISCLOSURE RULES

SEC Rule 15g-1 exempts the following penny-stock transactions from the disclosure requirements of Rules 15g-2 through 15g-6:

A. Transactions by broker/dealers that derived less than 5 percent of their revenues from penny-stock purchases and sales during a specified period. However, no such limited-activity exemption is available when the broker/dealer is a market maker in the penny stock that is the subject of the transaction.

B. Transactions in which the customer is an institutional accredited investor as defined in Regulation D under the Securities Act of 1933, including specifically defined banks, savings and loan associations, investment companies, business development companies, and employee benefit plans.

C. Transactions by issuers in limited offerings that satisfy the requirements of Regulation D under the 1933 Act, or transactions by an issuer not involving any public offering pursuant to Section 4(2) of the Securities Act of 1933;

D. Transactions in which the customer is the issuer or a director, officer, general partner or a direct or indirect beneficial owner of more than 5 percent of any class of equity security of the issuer of the penny stock involved in the transaction;

E. Transactions not recommended by a broker or dealer; or

F. Any other transaction or class of transactions or persons or classes of persons that, upon prior written request or upon its own motion, the Commission exempts by order as consistent with the public interest and protection of investors.

III. DISCLOSURE REQUIREMENTS

A. Risk Disclosure Document **(Effective July 15, 1992)**

SEC Rule 15g-2 requires broker/dealers to provide to customers for or with whom they are effecting penny-stock transactions, before the transactions, a standard risk disclosure document as set forth in Schedule 15G under the Rule (see page 18035 of the attached *Federal Register*. Among other things, the disclosure document describes the customer's right to disclosures of the: (1) current bid and ask quotation, if any; (2) compensation of

the broker/dealer and the salesperson in the transaction; and (3) monthly account statements showing the market value of each penny stock held in the customer's account. However, the document prescribed by Schedule 15G doesn't mention that those disclosure requirements are not effective until January 1, 1993. Under these circumstances, the SEC staff will permit NASD members to use and provide to customers a risk disclosure document that adds the following bracketed language to reflect the effective date:

> " Your rights
> Disclosures to you. Under penalty of federal law, [effective January 1, 1993] your brokerage firm must tell you the following information at two different times . . .
> * * * * *
> In addition to the items listed above, [effective January 1, 1993] your brokerage firm must send to you:
> • Monthly account statements . . . "
>
> (See page 18036 of the Federal Register)

In addition, the Commission has requested comment on whether the risk disclosure document should be required to be executed and returned by the customer, prior to the customer's first transaction in a penny stock with the broker/dealer, in order to evidence compliance with the rule.

B. Bid and Offer Quotations **(Effective January 1, 1993)**

SEC Rule 15g-3 requires broker/dealers to disclose to a customer with or for whom they plan to effect a penny-stock transaction current quotation prices (inside bid and offer) or similar market information regarding the penny stock before executing a transaction in the penny stock for the customer. This information also must be on the customer's confirmations.

C. Broker/Dealer Compensation **(Effective January 1, 1993)**

SEC Rule 15g-4 requires broker/dealers to disclose to customers for or with whom they effect penny-stock transactions, both prior to and when confirming the transaction, the amount of any compensation the broker/dealer received from the transactions.

D. Associated Persons' Compensation **(Effective January 1, 1993)**

SEC Rule 15g-5 requires broker/dealers effecting transactions in penny stocks with or for customers to disclose certain associated persons' compensation information to those customers (orally or in writing) before effecting a transaction and (in writing) when confirming each transaction at or before sending a confirmation to the customer.

E. Monthly Account Statements **(Effective January 1, 1993)**

SEC Rule 15g-6 requires broker/dealers that have sold penny stocks to customers in transactions not exempt under Rule 15g-1 to send those customers monthly account statements containing the following information regarding the securities within 10 days after the end of the month: (1) the issuer's name; (2) the number of shares, and (3) the estimated market value.

Relation to SEC Rule 15c2-6 (the "Penny Stock Cold Call Rule")

The Penny Stock Disclosure Rules are in addition to the suitability and record-keeping requirements of SEC Rule 15c2-6. The SEC has published for comment certain proposed amendments to conform certain provisions of the Cold Call Rule to the recently enacted disclosure rules. In particular, the Commission proposes to replace the definition of "designated security" in Rule 15c2-6(d)(2) with the definition of "penny stock" under Rule 3a51-1, and to replace the list of exempt transactions in 15c2-6(c)(1) with those enumerated in Rule 15g-1. Furthermore, the Commission proposes to amplify the risk disclosure document required by Rule 15g-2 to include a brief statement of the customer suitability process embodied in the Cold Call Rule. The SEC also proposes to retain the "established customer" exemption in Rule 15c2-6. The comment deadline was May 28, 1992. See SEC Release No. 34-30610 (April 20, 1992), 57 FR 18046 (April 28, 1992).

IV. FURTHER INFORMATION

Attached to this Notice is a copy of Rules 3a51-1 and 15g-1 through 15g-6. Any member that wants a copy of the entire 163-page SEC release discussing the rationale for the rules may obtain it by calling Zena Ferguson in the NASD Compliance Division at (202) 728-8230. A copy will be mailed promptly.

For further information or questions regarding these Rules, please contact Robert L.D. Colby,

Chief Counsel; John M. Ramsay, Branch Chief (Rules 15g-5 and g-6); Belinda Blaine, Attorney (Rules 3a51-1 and 15g-1); or Alexander Dill, Attorney (Rule 15g-2 and Schedule 15G, Rules 15g-3 and g-4); all at (202) 504-2418, Office of Chief Counsel, Division of Market Regulation, SEC, 450 Fifth Street, NW, Mail Stop 5-1, Washington, DC 20549. You also may contact Daniel M. Sibears, Director, NASD Compliance Division, at (202) 728-8959 or Gary Carleton, Senior Attorney, NASD Compliance Division, at (202) 728-8022.

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

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

Authority: 15 U.S.C. 77c, 77d, 77s, 77ttt, 78c, 78d, 78i, 78j, 78l, 78m, 78n, 78o, 78p, 78s, 78w, 78x, 79q, 79t, 80a-29, 80a-37, unless otherwise noted.

2. By adding § 240.3a51-1 to read as follows:

§ 240.3a51-1 Definition of penny stock.

For purposes of section 3(a)(51) of the Act, the term "penny stock" shall mean any equity security other than a security:

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

except that a security that is registered on the American Stock Exchange, Inc. pursuant to the listing criteria of the Emerging Company Marketplace, but that does not otherwise satisfy the requirements of paragraphs (b), (c), or (d) of this section, shall be a penny stock for purposes of section 15(b)(6) of the Act;

(b) That is issued by an investment company registered under the Investment Company Act of 1940;

(c) That is a put or call option issued by the Options Clearing Corporation;

(d) That has a price of five dollars or more;

(1) For purposes of paragraph (d) of this section:

(i) A security has a price of five dollars or more for a particular transaction if the security is purchased or sold in that transaction at a price of five dollars or more, excluding any broker or dealer commission, commission equivalent, mark-up, or mark-down; and

(ii) Other than in connection with a particular transaction, a security has a price of five dollars or more at a given time if the inside bid quotation is five dollars or more; *provided, however,* that if there is no such inside bid quotation, a security has a price of five dollars or more at a given time if the average of three or more interdealer bid quotations at specified prices displayed at that time in an interdealer quotation system, as defined in 17 CFR 240.15c2-7(c)(1), by three or more market makers in the security, is five dollars or more.

(iii) The term "inside bid quotation" shall mean the highest bid quotation for the security displayed by a market maker in the security on an automated interdealer quotation system that has the characteristics set forth in section 17B(b)(2) of the Act, or such other automated interdealer quotation system designated by the Commission for purposes of this section, at any time in which at least two market makers are contemporaneously displaying on such system bid and offer quotations for the security at specified prices.

(2) If a security is a unit composed of one or more securities, the unit price divided by the number of shares of the unit that are not warrants, options, rights, or similar securities must be five dollars or more, as determined in accordance with paragraph (d)(1) of this section, and any share of the unit that is a warrant, option, right, or similar security, or a convertible security, must have an exercise price or conversion price of five dollars or more;

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

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

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

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

(f) That is authorized, or approved for authorization upon notice of issuance, for quotation in the National Association of Securities Dealers' Automated Quotation system (NASDAQ), provided that 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 Association of Securities Dealers, Inc.;

except that a security that satisfies the requirements of this paragraph, but that does not otherwise satisfy the requirements of paragraphs (a), (b), (c), or (d) of this section, shall be a penny stock for purposes of section 15(b)(6) of the Act; or

(g) Whose issuer has:

(1) Net tangible assets (*i.e.*, total assets less intangible assets and liabilities) in excess of $2,000,000, if the issuer has been in continuous operation for at least three years, or $5,000,000, if the issuer has been in continuous operation for less than three years; or

(2) Average revenue of at least $6,000,000 for the last three years.

(3) For purposes of paragraph (g) of this section, net tangible assets or average revenues must be demonstrated by financial statements dated less than fifteen months prior to the date of the transaction that the broker or dealer has reviewed and has a reasonable basis for believing are accurate in relation to the date of the transaction, and:

(i) If the issuer is other than a foreign private issuer, are the most recent financial statements for the issuer that have been audited and reported on by an independent public accountant in accordance with the provisions of 17 CFR 210.2-02; or

(ii) If the issuer is a foreign private issuer, are the most recent financial statements for the issuer that have been filed with the Commission or furnished to the Commission pursuant to 17 CFR 240.12g3-2(b); *provided, however,* that if financial statements for the issuer dated less than fifteen months prior to the date of the transaction have not been filed with or furnished to the Commission, financial statements dated within fifteen months prior to the transaction shall be prepared in accordance with generally accepted accounting principles in the country of incorporation, audited in compliance with the requirements of that jurisdiction, and reported on by an accountant duly registered and in good standing in accordance with the regulations of that jurisdiction.

(4) The broker or dealer shall preserve, as part of its records, copies of the financial statements required by paragraph (g)(3) of this section for the period specified in 17 CFR 240.17a-4(b).

3. By adding § 240.15g-1 to read as follows:

§ 240.15g-1 Exemptions for certain transactions.

The following transactions shall be exempt from 17 CFR 240.15g-2, 17 CFR 240.15g-3, 17 CFR 240.15g-4, 17 CFR 240.15g-5, and 17 CFR 240.15g-6:

(a) Transactions by a broker or dealer:

(1) Whose commissions, commission equivalents, mark-ups, and mark-downs from transactions in penny stocks during each of the immediately preceding three months and during eleven or more of the preceding twelve months, or during the immediately preceding six months, did not exceed five percent of its total

commissions, commission equivalents, mark-ups, and mark-downs from transactions in securities during those months; and

(2) Who has not been a market maker in the penny stock that is the subject of the transaction in the immediately preceding twelve months.

Note: Prior to April 28, 1993, commissions, commission equivalents, mark-ups, and mark-downs from transactions in designated securities, as defined in 17 CFR 240.15c2-6(d)(2) as of April 15, 1992, may be considered to be commissions, commission equivalents, mark-ups, and mark-downs from transactions in penny stocks for purposes of paragraph (a)(1) of this section.

(b) Transactions in which the customer is an institutional accredited investor, as defined in 17 CFR 230.501(a)(1), (2), (3), (7), or (8).

(c) Transactions that meet the requirements of Regulation D (17 CFR 230.501–230.508), or transactions with an issuer not involving any public offering pursuant to section 4(2) of the Securities Act of 1933.

(d) Transactions in which the customer is the issuer, or a director, officer, general partner, or direct or indirect beneficial owner of more than five percent of any class of equity security of the issuer, of the penny stock that is the subject of the transaction.

(e) Transactions that are not recommended by the broker or dealer.

(f) Any other transaction or class of transactions or persons or class of persons that, upon prior written request or upon its own motion, the Commission conditionally or unconditionally exempts by order as consistent with the public interest and the protection of investors.

4. By adding § 240.15g-2 to read as follows:

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

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.

5. By adding section 240.15g-3 to read as follows:

§ 240.15g-3 Broker or dealer disclosure of quotations and other information relating to the penny stock market.

(a) *Requirement.* It shall be unlawful for a broker or dealer to effect a transaction in any penny stock with or for the account of a customer unless such broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the following information:

(1) The inside bid quotation and the inside offer quotation for the penny stock.

(2) If paragraph (a)(1) of this section does not apply because of the absence of an inside bid quotation and an inside offer quotation:

(i) With respect to a transaction effected with or for a customer on a principal basis (other than as provided in paragraph (a)(2)(ii) of this section):

(A) The dealer shall disclose its offer price for the security:

(1) If during the previous five days the dealer has effected no fewer than three *bona fide* sales to other dealers consistently at its offer price for the security current at the time of those sales, and

(2) If the dealer reasonably believes in good faith at the time of the transaction with the customer that its offer price accurately reflects the price at which it is willing to sell one or more round lots to another dealer. For purposes of paragraph (a)(2)(i)(A) of this section, "consistently" shall constitute, at a minimum, seventy-five percent of the dealer's *bona fide* interdealer sales during the previous five-day period, and, if the dealer has effected only three *bona fide* inter-dealer sales during such period, all three of such sales.

(B) The dealer shall disclose its bid price for the security:

(1) If during the previous five days the dealer has effected no fewer than three *bona fide* purchases from other dealers consistently at its bid price for the security current at the time of those purchases, and

(2) If the dealer reasonably believes in good faith at the time of the transaction with the customer that its bid price accurately reflects the price at which it is willing to buy one or more round lots from another dealer. For purposes of paragraph (a)(2)(i)(B) of this section, "consistently" shall constitute, at a minimum, seventy-five percent of the dealer's *bona fide* interdealer purchases during the previous five-day period, and, if the dealer has effected only three *bona fide* inter-dealer purchases during such period, all three of such purchases.

(C) If the dealer's bid or offer prices to the customer do not satisfy the criteria of paragraphs (a)(2)(i)(A) or (a)(2)(i)(B) of this section, the dealer shall disclose to the customer:

(1) That it has not effected inter-dealer purchases or sales of the penny stock consistently at its bid or offer price, and

(2) The price at which it last purchased the penny stock from, or sold the penny stock to, respectively, another dealer in a *bona fide* transaction.

(ii) With respect to transactions effected by a broker or dealer with or for the account of the customer:

(A) On an agency basis or

(B) On a basis other than as a market maker in the security, where, after having received an order from the customer to purchase a penny stock, the dealer effects the purchase from another person to offset a contemporaneous sale of the penny stock to such customer, or, after having received an order from the customer to sell the penny stock, the dealer effects the sale to another person to offset a contemporaneous purchase from such customer, the broker or dealer shall disclose the best independent interdealer bid and offer prices for the penny stock that the broker or dealer obtains through reasonable diligence. A broker-dealer shall be deemed to have exercised reasonable diligence if it obtains quotations from three market makers in the security (or all known market makers if there are fewer than three).

(3) With respect to bid or offer prices and transaction prices disclosed pursuant to paragraph (a) of this section, the broker or dealer shall disclose the number of shares to which the bid and offer prices apply.

(b) *Timing.* (1) The information described in paragraph (a) of this section:

(i) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(ii) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b-10 of this chapter.

(2) A broker or dealer, at the time of making the disclosure pursuant to paragraph (b)(1)(i) of this section, shall make and preserve as part of its records, a record of such disclosure for the period specified in 17 CFR 240.17a-4(b).

(c) *Definitions.* For purposes of this section:

(1) The term *bid price* shall mean the price most recently communicated by the dealer to another broker or dealer at which the dealer is willing to purchase one or more round lots of the penny stock, and shall not include indications of interest.

(2) The term *offer price* shall mean the price most recently communicated by the dealer to another broker or dealer at which the dealer is willing to sell one or

more round lots of the penny stock, and shall not include indications of interest.

(3) The term *inside bid quotation* for a security shall mean the highest bid quotation for the security displayed by a market maker in the security on a Qualifying Electronic Quotation System, at any time in which at least two market makers are contemporaneously displaying on such system bid and offer quotations for the security at specified prices.

(4) The term *inside offer quotation* for a security shall mean the lowest offer quotation for the security displayed by a market maker in the security on a Qualifying Electronic Quotation System, at any time in which at least two market makers are contemporaneously displaying on such system bid and offer quotations for the security at specified prices.

(5) The term *Qualifying Electronic Quotation System* shall mean an automated interdealer quotation system that has the characteristics set forth in section 17B(b)(2) of the Act, or such other automated interdealer quotation system designated by the Commission for purposes of this section.

6. By adding § 240.15g–4 to read as follows:

§ 240.15g–4 Disclosure of compensation to brokers or dealers.

Preliminary Note: Brokers and dealers may wish to refer to Securities Exchange Act Release No. 30608 (April 20, 1992) for a discussion of the procedures for computing compensation in active and competitive markets, inactive and competitive markets, and dominated and controlled markets.

(a) *Disclosure requirement.* It shall be unlawful for any broker or dealer to effect a transaction in any penny stock for or with the account of a customer unless such broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the aggregate amount of any compensation received by such broker or dealer in connection with such transaction.

(b) *Timing.* (1) The information described in paragraph (a) of this section:

(i) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(ii) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b–10.

(2) A broker or dealer, at the time of making the disclosure pursuant to paragraph (b)(1)(i) of this section, shall make and preserve as part of its records, a record of such disclosure for the period specified in 17 CFR 240.17a–4(b).

(c) *Definition of Compensation.* For purposes of this section, *compensation* means, with respect to a transaction in a penny stock:

(1) If a broker is acting as agent for a customer, the amount of any remuneration received or to be received by it from such customer in connection with such transaction;

(2) If, after having received a buy order from a customer, a dealer other than a market maker purchased the penny stock as principal from another person to offset a contemporaneous sale to such customer or, after having received a sell order from a customer, sold the penny stock as principal to another person to offset a contemporaneous purchase from such customer, the difference between the price to the customer and such contemporaneous purchase or sale price; or

(3) If the dealer otherwise is acting as principal for its own account, the difference between the price to the customer and the prevailing market price.

(d) *"Active and competitive"* market. For purposes of this section only, a market may be deemed to be "active and competitive" in determining the prevailing market price with respect to a transaction by a market maker in a penny stock if the aggregate number of transactions effected by such market maker in the penny stock in the five business days preceding such transaction is less than twenty percent of the aggregate number of all transactions in the penny stock reported on a Qualifying Electronic Quotation System (as defined in 17 CFR 240.15g–3(c)(5)) during such five-day period. No presumption shall arise that a market is not "active and competitive" solely by reason of a market maker not meeting the conditions specified in this paragraph.

7. By adding § 240.15g–5 to read as follows:

§ 240.15g–5 Disclosure of compensation of associated persons in connection with penny stock transactions.

(a) *General.* 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 the broker or dealer discloses to such customer, within the time periods and in the manner required by paragraph (b) of this section, the aggregate amount of cash compensation that any associated person of the broker or dealer who is a natural person and has communicated with the customer concerning the transaction at or prior to receipt of the customer's transaction order, other than any person whose function is solely clerical or ministerial, has received or will receive from any source in connection with the transaction and that is determined at or prior to the time of the transaction, including separate disclosure, if applicable, of the source and amount of such compensation that is not paid by the broker or dealer.

(b) *Timing.* (1) The information described in paragraph (a) of this section:

(i) Shall be provided to the customer orally or in writing prior to effecting any transaction with or for the customer for the purchase or sale of such penny stock; and

(ii) Shall be given or sent to the customer in writing, at or prior to the time that any written confirmation of the transaction is given or sent to the customer pursuant to 17 CFR 240.10b–10.

(2) A broker or dealer, at the time of making the disclosure pursuant to paragraph (b)(1)(i) of this section, shall make and preserve as part of its records, a record of such disclosure for the period specified in 17 CFR 240.17a–4(b).

(c) *Contingent compensation arrangements.* Where a portion or all of the cash or other compensation that the associated person may receive in connection with the transaction may be determined and paid following the transaction based on aggregate sales volume levels or other contingencies, the written disclosure required by paragraph (b)(1)(ii) of this section shall state that fact and describe the basis upon which such compensation is determined.

8. By adding § 240.15g–6 to read as follows:

§ 240.15g–6 Account statements for penny stock customers.

(a) *Requirement.* It shall be unlawful for any broker or dealer that has effected the sale to any customer, other than in a transaction that is exempt pursuant to 17 CFR 240.15g–1, of any security that is a penny stock on the last trading day of any calendar month, or any successor of such broker or dealer, to fail to give or send to such customer a written statement containing the information described in paragraphs (c) and (d) of this section with respect to each such month in which such security is held for the customer's account with the broker or dealer, within ten days following the end of such month.

(b) *Exemptions.* A broker or dealer shall be exempted from the requirement

of paragraph (a) of this section under either of the following circumstances:

(1) If the broker or dealer does not effect any transactions in penny stocks for or with the account of the customer during a period of six consecutive calendar months, then the broker or dealer shall not be required to provide monthly statements for each quarterly period that is immediately subsequent to such six-month period and in which the broker or dealer does not effect any transaction in penny stocks for or with the account of the customer, *provided* that the broker or dealer gives or sends to the customer written statements containing the information described in paragraphs (d) and (e) of this section on a quarterly basis, within ten days following the end of each such quarterly period.

(2) If, on all but five or fewer trading days of any quarterly period, a security has a price of five dollars or more, the broker or dealer shall not be required to provide a monthly statement covering the security for subsequent quarterly periods, until the end of any such subsequent quarterly period on the last trading day of which the price of the security is less than five dollars.

(c) *Price Determinations.* For purposes of paragraphs (a) and (b) of this section, the price of a security on any trading day shall be determined at the close of business in accordance with the provisions of 17 CFR 240.3a51-1(d)(1).

(d) *Market and price information.* The statement required by paragraph (a) of this section shall contain at least the following information with respect to each penny stock covered by paragraph (a) of this section, as of the last trading day of the period to which the statement relates:

(1) The identity and number of shares or units of each such security held for the customer's account; and

(2) The estimated market value of the security, to the extent that such estimated market value can be determined in accordance with the following provisions:

(i) The highest inside bid quotation for the security on the last trading day of the period to which the statement relates, multiplied by the number of shares or units of the security held for the customer's account; or

(ii) If paragraph (d)(2)(i) of this section is not applicable because of the absence of an inside bid quotation, and if the broker or dealer furnishing the statement has effected at least ten separate Qualifying Purchases in the security during the last five trading days of the period to which the statement relates, the weighted average price per share paid by the broker or dealer in all Qualifying Purchases effected during such five-day period, multiplied by the number of shares or units of the security held for the customer's account; or

(iii) If neither of paragraphs (d)(2)(i) nor (d)(2)(ii) of this section is applicable, a statement that there is "no estimated market value" with respect to the security.

(e) *Legend.* In addition to the information required by paragraph (d) of this section, the written statement required by paragraph (a) of this section shall include a conspicuous legend that is identified with the penny stocks described in the statement and that contains the following language:

If this statement contains an estimated value, you should be aware that this value may be based on a limited number of trades or quotes. Therefore, you may not be able to sell these securities at a price equal or near to the value shown. However, the broker-dealer furnishing this statement may not refuse to accept your order to sell these securities. Also, the amount you receive from a sale generally will be reduced by the amount of any commissions or similar charges. If an estimated value is not shown for a security, a value could not be determined because of a lack of information.

(f) *Preservation of records.* Any broker or dealer subject to this section shall preserve, as part of its records, copies of the written statements required by paragraph (a) of this section and keep such records for the periods specified in 17 CFR 240.17a-4(b).

(g) *Definitions.* For purposes of this section:

(1) The term *Quarterly period* shall mean any period of three consecutive full calendar months.

(2) The *inside bid quotation* for a security shall mean the highest bid quotation for the security displayed by a market maker in the security on a Qualifying Electronic Quotation System, at any time in which at least two market makers are contemporaneously displaying on such system bid and offer quotations for the security at specified prices.

(3) The term *Qualifying Electronic Quotation System* shall mean an automated interdealer quotation system that has the characteristics set forth in section 17B(b)(2) of the Act, or such other automated interdealer quotation system designated by the Commission for purposes of this section.

(4) The term *Qualifying Purchases* shall mean *bona fide* purchases by a broker or dealer of a penny stock for its own account, each of which involves at least 100 shares, but excluding any block purchase involving more than one percent of the outstanding shares or units of the security.

9. By adding § 240.15g-100 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. The information contained in Schedule 15G ("Schedule") must be reproduced in its entirety. No language of the document may be omitted, added to, or altered in any way. No material may be given to a customer that is intended in any way to detract from, rebut, or contradict the Schedule.

B. The document entitled "Important Information on Penny Stocks" must be distributed as the first page of Schedule 15G, and on one page only. The remainder of Schedule 15G, entitled "Further Information," explains the items discussed in the first page in greater detail.

C. The disclosures made through the Schedule are in addition to any other disclosure(s) that are required to be made under the federal securities laws, including without limitation the disclosures required pursuant to the rules adopted under Sections 15(c)(1), 15(c)(2), and 15(g) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(c) (1) and (2), and 15 U.S.C. 78o(g), respectively.

D. The format and typeface of the document must be reproduced as presented in the Schedule. The document may be reproduced from the Schedule by photographic copying that is clear, complete, and at least satisfies the type-size requirements set forth below for printing. In the alternative, the document may be printed and must meet the following criteria regarding typeface:

1. Words appearing in capital letters in the Schedule must be reproduced in capital letters and printed in bold-face roman type at least as large as ten-point modern type and at least two points leaded.

2. Words appearing in lower-case letters must be reproduced in lower-case roman type at least as large as ten point modern type and at least two points leaded.

3. Words that are underlined in the document must be underlined in reproduction and appear in bold-faced roman type at least as large as ten point modern type and at least two points leaded, and meet the criteria for lower-case or capital letters in paragraphs (1) and (2) above, whichever is applicable.

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

This statement is required by the U.S. Securities and Exchange Commission (SEC) and contains important information on penny stocks. You are urged to read it before making a purchase or sale.

Penny stocks can be very risky.

• Penny stocks are low-priced shares of small companies not traded on an exchange or quoted on NASDAQ. Prices often are not available. Investors in penny stocks often are unable to sell stock back to the dealer that sold them the stock. Thus, you may lose your investment. Be cautious of newly issued penny stock.

• Your salesperson is not an impartial advisor but is paid to sell you the stock. Do not rely only on the salesperson, but seek outside advice before you buy any stock. If you have problems with a salesperson, contact the firm's compliance officer or the regulators listed below.

Information you should get.

• *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 mail a confirmation of these prices to you after the trade.

• You will need this price information to determine what profit, 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. 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.

Brokers' duties and customer's rights and remedies.

• If you are a victim of fraud, you may have rights and remedies under state and federal law. You can get the disciplinary history of a salesperson or firm from the NASD at 1-800-289-9999, and additional information from your state securities official, at the North American Securities Administrators Association's central number: (202) 737-0900. You also may contact the SEC with complaints at (202) 272-7440.

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Further Information

The securities being sold to you have not been approved or disapproved by the Securities and Exchange Commission. Moreover, the Securities and Exchange Commission 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.

Generally, penny stock is a security that:

• Is priced under five dollars;

• Is *not* traded on a national stock exchange or on NASDAQ (the NASD's automated quotation system for actively traded stocks);

• May be listed in the "pink sheets" or the NASD OTC Bulletin Board;

• Is issued by a company that has less than $5 million in net tangible assets and has been in business less than three years, by a company that has under $2 million in net tangible assets and has been in business for at least three years, or by a company that has revenues of $6 million for 3 years.

Use Caution When Investing in Penny Stocks

1. *Do not make a hurried investment decision.* High-pressure sales techniques can be a warning sign of fraud. The salesperson is not an impartial advisor, but is paid for selling stock to you. The salesperson also does not have to watch your investment for you. Thus, you should think over the offer and seek outside advice. Check to see if the information given by the salesperson differs from other information you may have. Also, it is illegal for salespersons to promise that a stock will increase in value or is risk-free, or to guarantee against loss. If you think there is a problem, ask to speak with a compliance official at the firm, and, if necessary, any of the regulators referred to in this statement.

2. *Study the company issuing the stock.* Be wary of companies that have no operating history, few assets, or no defined business purpose. These may be sham or "shell" corporations. Read the prospectus for the company carefully before you invest. Some dealers fraudulently solicit investors' money to buy stock in sham companies, artificially inflate the stock prices, then cash in their profits before public investors can sell their stock.

3. *Understand the risky nature of these stocks.* You should be aware that you may lose part or all of your investment. Because of large dealer spreads, you will not be able to sell the stock immediately back to the dealer at the same price it sold the stock to you. In some cases, the stock may fall quickly in value. New companies, whose stock is sold in an "initial public offering," often are riskier investments. Try to find out if the shares the salesperson wants to sell you are part of such an offering. Your salesperson must give you a "prospectus" in an initial public offering, but the financial condition shown in the prospectus of new companies can change very quickly.

4. *Know the brokerage firm and the salespeople with whom you are dealing.* Because of the nature of the market for penny stock, you may have to rely solely on the original brokerage firm that sold you the stock for prices and to buy the stock back from you. Ask the National Association of Securities Dealers, Inc. (NASD) or your state securities regulator, which is a member of the North American Securities Administrators Association, Inc. (NASAA), about the licensing and disciplinary record of the brokerage firm and the salesperson contacting you. The telephone numbers of the NASD and NASAA are listed on the first page of this document.

5. *Be cautious if your salesperson leaves the firm.* If the salesperson who sold you the stock leaves his or her firm, the firm may reassign your account to a new salesperson. If you have problems, ask to speak to the firm's branch office manager or a compliance officer. Although the departing salesperson may ask you to transfer your stock to his or her new firm, you do not have to do so. Get information on the new firm. Be wary of requests to sell your securities when the salesperson transfers to a new firm. Also, you have the right to get your stock certificate from your selling firm. You do not have to leave the certificate with that firm or any other firm.

Your Rights

Disclosures to you. Under penalty of federal law, your brokerage firm must tell you the following information at two different times—*before* you agree to buy or sell a penny stock, and after the trade, by *written confirmation:*

• *The bid and offer price quotes for penny stock, and the number of shares to which the quoted prices apply.* The *bid* and *offer* quotes are the wholesale prices at which dealers trade among themselves. These prices give you an idea of the market value of the stock. The dealer must tell you these price quotes if they appear on an automated quotation system approved by the SEC. If not, the dealer must use its own quotes or trade prices. You should calculate the *spread,* the difference between the bid and offer quotes, to help decide if buying the stock is a good investment.

A lack of quotes may mean that the market among dealers is not active. It thus may be difficult to resell the stock. You also should be aware that the actual price charged to you for the stock may differ from the price quoted to you for 100 shares. You should therefore determine, before you agree to a purchase, what the actual sales price (before the *markup*) will be for the exact number of shares you want to buy.

• *The brokerage firm's compensation for the trade.* A *markup* is the amount a dealer adds to the wholesale offer price of the stock and a *markdown* is the amount it subtracts from the wholesale bid price of the stock as *compensation.* A markup/markdown usually serves the same role as a broker's commission on a trade. Most of the firms in the penny stock market will be dealers, not brokers.

• *The compensation received by the brokerage firm's salesperson for the trade.* The brokerage firm must disclose to you, as a total sum, the cash compensation of your salesperson for the trade that is known at the time of the trade. The firm must describe in the written confirmation the nature of any other compensation of your salesperson that is unknown at the time of the trade.

In addition to the items listed above, your brokerage firm must send to you:

• *Monthly account statements. In general, your brokerage firm must send you a monthly 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.

Legal remedies. If penny stocks are sold to you in violation of your rights listed above, or other federal or state securities laws, you may be able to cancel your purchase and get

your money back. If the stocks are sold in a fraudulent manner, you may be able to sue the persons and firms that caused the fraud for damages. If you have signed an arbitration agreement, however, you may have to pursue your claim through arbitration. You may wish to contact an attorney. The SEC is not authorized to represent individuals in private litigation.

However, to protect yourself and other investors, you should report any violations of your brokerage firm's duties listed above and other securities laws to the SEC, the NASD, or your state securities administrator at the telephone numbers on the first page of this document. These bodies have the power to stop fraudulent and abusive activity of salespersons and firms engaged in the securities business. Or you can write to the SEC at 450 Fifth St., NW., Washington, DC 20549; the NASD at 1735 K Street, NW., Washington, DC 20006; or NASAA at 555 New Jersey Avenue, NW., Suite 750, Washington, DC 20001. NASAA will give you the telephone number of your state's securities agency. If there is any disciplinary record of a person or a firm, the NASD, NASAA, or your state securities regulator will send you this information if you ask for it.

Market Information

The market for penny stocks. Penny stocks usually are not listed on an exchange or quoted on the NASDAQ system. Instead, they are traded between dealers on the telephone in the "over-the-counter" market. The NASD's OTC Bulletin Board also will contain information on some penny stocks. At times, however, price information for these stocks is not publicly available.

Market domination. In some cases, only one or two dealers, acting as "market makers," may be buying and selling a given stock. You should first ask if a firm is acting as a *broker* (your agent) or as a dealer. A *dealer* buys stock itself to fill your order or already owns the stock. A *market maker* is a dealer who holds itself out as ready to buy and sell stock on a regular basis. If the firm is a market maker, ask how many other market makers are dealing in the stock to see if the firm (or group of firms) dominates the market. When there are only one or two market makers, there is a risk that the dealer or group of dealers may control the market in that stock and set prices that are not based on competitive forces. In recent years, some market makers have created fraudulent markets in certain penny stocks, so that stock prices rose suddenly, but collapsed just as quickly, at a loss to investors.

Mark-ups and mark-downs. The actual price that the customer pays usually includes the mark-up or mark-down. Markups and markdowns are direct profits for the firm and its salespeople, so you should be aware of such amounts to assess the overall value of the trade.

The "spread." The difference between the bid and offer price is the spread. Like a mark-up or mark-down, the spread is another source of profit for the brokerage firm and compensates the firm for the risk of owning the stock. A large spread can make a trade very expensive to an investor. For some penny stocks, the spread between the bid and offer may be a large part of the purchase price of the stock. Where the bid price is much lower than the offer price, the market value of the stock must rise substantially before the stock can be sold at a profit. Moreover, an investor may experience substantial losses if the stock must be sold immediately.

Example: If the bid is $0.04 per share and the offer is $0.10 per share, the spread (difference) is $0.06, which appears to be a small amount. But you would lose $0.06 on every share that you bought for $0.10 if you had to sell that stock immediately to the same firm. If you had invested $5,000 at the $0.10 offer price, the market maker's repurchase price, at $0.04 bid, would be only $2,000; thus you would lose $3,000, or more than half of your investment, if you decided to sell the stock. In addition, you would have to pay compensation (a "mark-up," "mark-down," or commission) to buy and sell the stock.

In addition to the amount of the spread, the price of your stock must rise enough to make up for the compensation that the dealer charged you when it first sold you the stock. Then, when you want to resell the stock, a dealer again will charge compensation, in the form of a markdown. The dealer subtracts the markdown from the price of the stock when it buys the stock from you. Thus, to make a profit, the bid price of your stock must rise above the amount of the original spread, the markup, and the markdown.

Primary offerings. Most penny stocks are sold to the public on an ongoing basis. However, dealers sometimes sell these stocks in initial public offerings. You should pay special attention to stocks of companies that have never been offered to the public before, because the market for these stocks is untested. Because the offering is on a first-time basis, there is generally no market information about the stock to help determine its value. The federal securities laws generally require broker-dealers to give investors a "prospectus," which contains information about the objectives, management, and financial condition of the issuer. In the absence of market information, investors should read the company's prospectus with special care to find out if the stocks are a good investment. However, the prospectus is only a description of the current condition of the company. The outlook of the start-up companies described in a prospectus often is very uncertain.

For more information about penny stocks, contact the Office of Filings, Information, and Consumer Services of the U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549, (202) 272-7440.

Dated: April 20, 1992.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

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