



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

October 12, 2000

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
United States House of Representatives
2125 Rayburn House Office Building
Washington, D.C. 20515-6115

Dear Congressman Dingell:

On October 14, 1998, you asked for periodic updates of the SEC's efforts to address the recommendations of the General Accounting Office (GAO) Report entitled SEC Enforcement: Actions Reported on GAO and SEC Recommendations Related to Microcap Stock Fraud (GAO Report). The GAO Report details the numerous actions that the SEC and the self-regulatory organizations (SROs) have taken to combat microcap stock fraud as well as certain areas where further improvements can be made. I have asked my staff to prepare the attached memorandum to update you about our progress on the outstanding GAO recommendations. This is our third report, following our reports to you of March 31, 1999, and September 30, 1999.

The attached report reflects the ongoing efforts and accomplishments of the Commission and SROs to combat microcap fraud. We look forward to working with you on our continued efforts in this important area of investor protection. We would be happy to update you if there are any other further significant developments.

If you have any questions, please contact me or Annette Nazareth, the Director of the Division of Market Regulation, at (202) 942-0090.

Sincerely,

A handwritten signature in black ink, appearing to be "Arthur Levitt".

Arthur Levitt

Enclosure

MEMORANDUM

TO: Arthur Levitt, Chairman

FROM: Annette L. Nazareth, Director 
Division of Market Regulation

DATE: October 11, 2000

RE: Response to Congressman John D. Dingell Regarding SEC and SRO Efforts
Relating to Fraud in Microcap Stocks

This memorandum responds to Congressman Dingell's request for semi-annual updates about the Securities and Exchange Commission's (SEC) efforts to address General Accounting Office (GAO) recommendations on initiatives to combat microcap fraud. This final report reflects SEC and self-regulatory organization (SRO) efforts to address the GAO's recommendations, subject to certain legislative efforts that are still needed.

I. BACKGROUND

On December 12, 1997, Congressman Dingell asked the GAO to conduct a comprehensive review of fraud involving microcap stocks. The GAO responded with a report, SEC Enforcement: Actions Reported on GAO and SEC Recommendations Related to Microcap Stock Fraud (GAO/GGD-98-204, September 30, 1998)(GAO Report), which reviewed the status of SEC and SRO actions taken in response to recommendations made in prior GAO and SEC reports. As the GAO Report noted, the SEC and SROs have taken numerous actions to combat microcap stock fraud. The GAO Report further noted that actions on four recommendations had not been completed: (1) migration of unscrupulous brokers from the securities industry to other financial services industries; (2) reporting and trend analysis of violations found in broker-dealer examinations; (3) the modernization of the Central Registration Depository (CRD) to improve oversight of problem brokers and public access to broker disciplinary histories; and (4) access of information to investors about broker disciplinary histories before activity occurs in an account.

As set forth below, the SEC and SROs have addressed these recommendations. In response to our previous report on March 31, 1999, on these four GAO recommendations, Congressman Dingell wrote the GAO on April 13, 1999, and noted that legislation on two matters would assist the efforts of the SEC and SROs to combat microcap fraud. These two areas involved migration of unscrupulous brokers and the CRD. We have also outlined additional efforts by the SEC and the SROs to combat microcap fraud.

II. STATUS OF RECOMMENDATIONS

1. Migration of Rogue Brokers

The GAO Report raised concerns about the migration of unscrupulous brokers into other segments of the financial services industry, such as banking and insurance. The GAO recommended that the Department of Treasury work with the SEC and other financial regulators to increase disclosure of CRD information so that regulators can consider a broker's disciplinary history in allocating examination resources, and employers can use the information in making hiring decisions.

As discussed below, the NASD has significantly revamped the CRD system so that information about brokers' disciplinary histories is made readily accessible to securities regulators and prospective employers. Disclosure on the Internet, however, has been delayed pending legislative changes. See discussion at § II.3.

As we stated in our September 1999 submission, legislation is also needed in connection with the migration of unscrupulous persons from the banking and insurance sectors into the securities industry. U.S. federal securities laws do not currently prevent persons subject to disciplinary findings by state securities, banking, and insurance commissions, and federal banking agencies¹ from entering the securities industry. We hope that progress will be made in amending the Securities Exchange Act of 1934 (Exchange Act) to make persons subject to a "statutory disqualification"² if they have been found by a state securities or insurance commission, or state or federal banking agency, to have committed certain fraudulent acts or violated the statutes enforced by these agencies. We understand that Congressman Dingell is seeking a legislative solution.³

2. Reporting and Trend Analysis of Violations Found in Examinations

The GAO Report recommended that the SEC explore ways to record and maintain information on the number of each type of deficiency and violation found during on-site examinations of broker-dealers, and include this information in its examination tracking system in order to be able to analyze trends in deficiencies and violations. As previously reported, this GAO recommendation has been addressed. Staff from the Office of Compliance Inspections and Examinations ("OCIE") has implemented a new examination tracking system called the "Super Tracking and Reporting System" (STARS). STARS continues to operate effectively in headquarters and in each of the Commission's regional

¹ These would include the Office of Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

² See Exchange Act § 3(a)(39).

³ See Letter dated April 13, 1999, from the Honorable John D. Dingell to the Honorable David M. Walker, Comptroller General, U.S. General Accounting Office.

and district offices. In addition, OCIE staff continues to store on the Zyindex system the text of all examination reports as they are completed. As indicated previously, this system enables the examination staff to conduct searches of reports using keywords and compile trends analyses.

3. Central Registration Depository

As described below, the NASD has now deployed Web CRD; however, legislation is needed to permit public disclosure on the Internet of broker disciplinary history.

a. Status of Web CRD: Our first submission to Congressman Dingell contained an analysis of the December 1998 quarterly report submitted by the NASD, as well as a discussion of the background of the CRD modernization effort. Our second submission provided an overview of action taken during the first half of 1999, including the roll out of the modernized Web CRD system on August 16, 1999. The NASD submitted a final report in November 1999, which detailed the deployment of Web CRD, including the first six weeks of its use.

Since our last report and as of the end of May, more than 1.2 million broker-dealer forms have been processed by the Web CRD system. An average of approximately 48,000 registrations are now being approved each week. The NASD continues to work closely with the user community (other SROs, state regulators, and industry representatives) to monitor the performance of the licensing system, as well as to seek input for future enhancements. Regular meetings with policy groups, technology departments, and registrations managers provide an on-going forum for issues that may arise.

In April 2000, the NASD formally retired the old Legacy CRD system. According to the NASD, all Legacy data has been converted to Web CRD format and is available through either the Web CRD or through an Oracle database.

b. Public Disclosure: In both our March and September 1999 submissions, we noted that the NASD had delayed its plans to display disciplinary information on the web page because of concerns regarding immunity in state law defamation cases. We noted that we had discussed the need for an amendment to the Exchange Act with Congressman Dingell's staff. In April 1999, Congressman Dingell sent a letter to the GAO detailing the SEC and Department of Justice (DOJ) responses to the GAO report. Congressman Dingell noted that legislative action was required to allow the NASD to implement plans to display disciplinary information on its web page, and that he would be seeking a legislative solution so that investors can have Internet access to broker disciplinary histories. Our understanding is that various legislative avenues are being explored to resolve this issue.

4. Disclosure of Disciplinary History

As we noted in our March and September 1999 submissions, the SEC approved NASD Rule 2280, which requires NASD members to provide information on the

availability of broker disciplinary information to customers in writing, at least annually, along with the Internet web site address of the NASD's Public Disclosure Program (PDP), and a statement regarding the availability of an investor brochure describing the PDP. The NASD's rule gives its members the flexibility to determine whether to include the information on customer account statements or some other type of publication. Given the costs associated with alternative forms of disclosure, we believe that the NASD's approach is a reasonable method of disseminating this information.

III. OTHER ACTIONS

We are providing an update on other SEC and SRO actions to address microcap fraud since our last update.

- **Regulatory**

Rule 504 is the limited offering exemption designed to aid small businesses in raising seed capital without complying with Securities Act of 1933 (Securities Act) registration requirements. The freely tradable nature of securities issued in Rule 504 offerings facilitated a number of fraudulent market manipulations. The SEC adopted amendments to Rule 504 of Regulation D designed to deter microcap fraud while preserving the ability of legitimate small businesses to raise capital. See Securities Act Release No. 7644 (February 25, 1999). These amendments have had a positive impact on investor protection, substantially reducing the abuse of Rule 504, without hindering legitimate capital raising by small businesses.

The staff continues to set forth its view that the issuance of securities in consideration of a person's registration on (or visit to) an issuer's Internet web site would be an event of sale under the Securities Act. See Letters re: Andrew Jones and James Rutten (April 21, and May 24, 1999); Letter re: Simplystocks.com (Feb. 4, 1999). In the absence of registration or a valid exemption, such an issuance would violate Section 5 of the Securities Act. This interpretive position should reduce unregistered "give-aways" of purportedly "free" securities that become available for pump-and-dump schemes or other microcap fraud. In July 1999, our Enforcement Division brought and settled actions against promoters and Internet companies that offered and distributed free stock through online web sites without properly registering their offering.

In an interpretative letter to NASD Regulation, Inc., dated January 21, 2000, the staff advised that persons who hold securities in blank check companies are probably underwriters of those securities. While the facts and circumstances are determinative, Section 4(1) of the Securities Act may not be available for resales of these securities by promoters, affiliates, and their transferees, regardless of the length of time they may have held the securities. The design of the blank check companies is intended to allow these persons to introduce large quantities of securities into the public markets at the time of a business combination with an operating company. These sales are distributive in

character, not the ordinary trading transactions Section 4(1) exempts. In addition, the staff expressed its view that resale transactions of these securities, where the initial distribution was not accomplished through registration and conformance with Rule 419 under the Securities Act, cannot be done under Rule 144 because a scheme to evade registration may be involved, making the provision unavailable. The staff also cautioned about the applicability of Rules 101 and 102 of Regulation M in these situations. As a final matter, the staff noted that Rule 701, a registration exemptive rule for employee compensatory arrangements, would generally not be available for the securities of blank check companies.

The staff also expressed its concern over circumstances where, after a company is formed without either substantial capital or the prompt commencement of business, but in proximity to the company's efforts to have its securities traded in a public market, its closely-held securities are transferred to significant numbers of persons. In these circumstances, the staff suggested resales of the transferred securities in claimed reliance on Rule 144 may involve evasive schemes to avoid registration under the Securities Act. See Letter re: Harmony Trading Corporation (November 22, 1999).

In a letter to the Director of Listing Qualifications of Nasdaq, dated April 7, 2000, the staff addressed the newly-developing practice of utilizing blank check companies subject to the reporting requirements of the Exchange Act as targeted acquisition vehicles to transport their reporting status to non-reporting operating companies (so-called "back door" registration) – a practice seen to be desirable in light of the phase out of non-reporting companies from eligibility to trade on the NASD OTC Bulletin Board (OTCBB). In this letter, the staff opined that where an operating company is the acquiring entity, it could not succeed to the reporting obligation of a blank check company it acquires under Rule 12g-3(a) because the definition of "succession" in Rule 12b-2 requires "the direct acquisition of the assets comprising a going business." Nonetheless, the staff advised it would recommend "no action" in cases where the operating company provided the complete audited and pro forma financial statements required by Form 10 or Form 10-SB within 15 days of the succession. These filings are subject to the review and comment processes of the staff.

As we advised in our last update, on January 4, 1999, the SEC also approved amendments to NASD Rules 6530 and 6540 to limit quotations on the OTCBB to the securities of issuers that are current in their reports filed with the Commission or other regulatory authority, and to prohibit a member from quoting a security on the OTCBB unless the issuer has made current filings. On July 1, 1999, the NASD started phasing in these rules, which now have been fully implemented. The impact of these new rules has been significant: approximately 1,531 small issuers have registered with the Commission to avoid being removed from the OTCBB. During the implementation period, the Commission has received more than six times the number of Exchange Act registration statements than it previously received for a similar period. The Eligibility Rules will have a continuing impact because more companies will file Exchange Act registration statements so that their securities can be quoted on the OTCBB. This results in more information

being available about these companies because their reports are available on EDGAR. Also, the Commission now has regulatory oversight over these issuers because they are reporting companies.

In February 1999, the SEC repropoed amendments to Rule 15c2-11 to deter fraud in the over-the-counter (OTC) market. See Exchange Act Release No. 41110 (February 25, 1999). This rule governs the publication of quotations for securities in a medium other than a national securities exchange or Nasdaq. Commenters have said that the proposals are overly broad and are not focused on securities that are the subject of microcap fraud. We are now evaluating these comments and will shortly make a recommendation to the Commission for adoption.

The SEC also published notice of the NASD's rule filings to amend its Rules 2315 and 6740 to require broker-dealers to review current financial statement information about an OTC issuer before recommending its securities to retail customers. This proposal is currently under staff review.

On May 22, 2000, the Commission approved the NASD's trading and quotation halt rule that curtails the trading of problem securities, including microcap securities. NASD Rule 6545 halts quoting and trading of: (1) OTC securities that have been the subject of a foreign trading halt; (2) OTC derivatives when there is a trading halt in the underlying security; and (3) OTC securities when the issuer fails to comply with Rule 10b-17.

The NASD has proposed instituting a 12-month pilot program that would apply limit order protection to a select group of approximately 325 OTCBB securities. This measure is designed to deter microcap fraud by preventing market makers from trading ahead of customer limit orders. At the end of the pilot program, the NASD would evaluate whether and how limit order protection should be extended to the remaining OTCBB securities.

Also, the NASD recently submitted a proposal to require members that publish quotations in the electronic pink sheets (or any similar automated quotation system) to record and maintain priced quotations and unpriced indications of interest data and to report such quotation data to NASD Regulation upon request. Previously, real-time quotation data had not been available for quotations in the electronic Pink Sheets. This quotation data is necessary to reconstruct the market to obtain a complete understanding of potentially fraudulent or unusual activity.

The staff is also working with the securities industry to develop other measures to reduce microcap fraud. We are working with the NSCC/DTC, NYSE, NASD, and members of the SIA Clearing Committee on a data repository that will be used to store information that may be useful in detecting on-going fraudulent activities. The repository, located at the NASD, will receive daily information related to the clearing process from a number of

different sources, including clearing firms, the NYSE, the NASD, and NSCC/DTC. The clearing firms will be sending information on their correspondents' cancelled and "as-of" trades, proprietary account equity, and unsecured customer debits. The NYSE and NASD will send information on Regulation T extensions, and NSCC/DTC will send exception reports when a member dominates the market in a given security or holds a substantial amount of the DTC inventory in a given security. A pilot program using the NASD's INSITE software system is currently underway.

- **Education**

The SEC strongly believes that an educated investor provides the best defense—and offense—against securities fraud. Investors who know what questions to ask and how to detect fraud will be less likely to fall prey to con artists. Because they are more likely to report wrongdoing to the SEC and their state securities regulators, educated investors serve as an important early warning system to help regulators fight fraud.

In the months following our latest submission to Congressman Dingell, we have continued to update the "Investor Assistance and Complaints" section of the SEC's Web site. The pages comprising this section—at www.sec.gov/invkhome.htm—give investors detailed information and tips on saving, investing, and avoiding fraud, including microcap and Internet fraud. For example, in January 2000, we added to our "Search Key Topics" databank a new topic on microcap fraud that links to our brochure, "Microcap Stock: A Guide for Investors." More recently, in July 2000, we added several new topics that explain Rules 504, 505, and 506 under Regulation D, encouraging investors to exercise caution when investing in Regulation D companies. As you know, many microcap companies invoke Regulation D to avoid having to register with the SEC. Other recently posted topics describe how the OTCBB and Pink Sheets work, provide links to the SEC's penny stock rules, and warn investors about online newsletters and bulletin board postings.

Our Web site also features materials that tell investors where to find information about companies and how to file a complaint. In addition, we created a consolidated Web page on microcap fraud. This page allows investors to quickly and easily learn about the latest enforcement actions and initiatives in our ongoing fight against microcap fraud. Users can access the page using the "What's Hot" link at the top of the SEC's home page or from the Division of Enforcement's home page.

As a complement to our Web-based educational initiatives, we have continued to distribute several free publications that warn investors about microcap fraud and provide tips on how to invest wisely. These include:

Microcap Stock: A Guide for Investors—Released in February 1999, this brochure tells investors about microcap stocks, how to find information about companies

before investing, what “red flags” to consider, and where to turn if they run into trouble;

Internet Fraud: How to Avoid Internet Investment Scams—Released in October 1998 and updated in August 2000, Internet Fraud tells investors how to spot different types of Internet fraud, what the SEC is doing to fight Internet investment scams, and how to use the Internet to invest wisely;

Pump & Dump.con: Tips for Avoiding Stock Scams on the Internet—Released in September 2000, Pump & Dump offers investors tips for avoiding stock scams on the Internet by being skeptical, considering the source, and independently verifying web-based claims about stocks.

Cold Calling Alert—Released in September 1997, Cold Calling tells investors about their legal rights, how to deal with cold calls, how to stop them, and how to evaluate investment opportunities that come over the telephone.

Investors can get these and other helpful brochures from the SEC’s toll-free publications line at (800) 732-0330 or from the “Investor Assistance and Complaints” section of our Web site at <www.sec.gov>. To assure that as many Americans as possible have access to these brochures, we recently began distributing them through the General Services Administration’s Consumer Information Center.

The SEC also reaches out to investors on both the national and grass-roots levels through investors’ town meetings, our toll-free information line, the “Investor Assistance and Complaints” section of our Internet Web site, and the media. For example, over the past six years, we have participated in 38 investors’ town meetings across the country, educating investors on how to invest wisely and responding to their concerns. We also work with national and regional media to ensure that as many Americans as possible hear our investor education and protection messages and learn how to reach us.

In addition, we’ve formed strategic alliances to fully leverage our educational resources. For example, in November 1999, we joined forces with the U.S. Postal Inspection Service, AARP, the Council of Better Business Bureaus, the Department of Justice, the Federal Trade Commission, and the National Association of Attorneys General to launch “Project Know Fraud,” an unprecedented effort that delivered tips on avoiding telemarketing fraud to every household in America. And in the spring of 2000, we joined the U.S. Department of the Treasury’s “National Partnership for Financial Empowerment,” a coalition of more than 50 government agencies, consumer groups, financial services organizations, and private sector companies that seek to raise financial literacy levels and help Americans to get the facts they need to save, invest, and avoid financial fraud.

- **Enforcement**

Combating microcap fraud continues to be a top priority of the Enforcement Division. The Commission has brought a number of significant microcap enforcement actions and remains committed to devoting considerable resources to combating fraud in the microcap market. In addition, as microcap fraud continues to migrate to the Internet, we have recently devoted additional resources to our Internet fraud program.

Some of our more notable recent actions include:

Joint Effort with Criminal Authorities to Attack Microcap Fraud and Organized Crime on Wall Street

On June 14, 2000, the Commission charged 63 individuals and entities with a wide variety of illegal conduct involving microcap securities, including “pump-and-dump” manipulations of four securities, payments of bribes to broker-dealers, a private placement fraud sold in boiler-room style, and an investment adviser kickback and bribery scheme. The Commission also suspended trading in two securities. In related criminal prosecutions, the U.S. Attorney for the Southern District of New York and the Federal Bureau of Investigation indicted more than 100 defendants, including 11 alleged members and associates of organized crime families.

Steve Madden

On June 20, 2000, the Commission filed a civil injunctive action against Steve Madden, president of a footwear company underwritten by Stratton Oakmont, Inc. The Commission charged that Madden participated in the manipulation of 22 IPOs underwritten by Stratton Oakmont and Monroe Parker Securities, Inc., over a six-year period, including the IPO of his own company. The U.S. Attorney’s Offices for the Eastern District of New York and the Southern District of New York announced related criminal charges the same day.

Sterling Foster

On February 9, 2000, the Commission filed its fourth civil action arising from the massive securities fraud conducted through boiler room Sterling Foster & Company, Inc. In the most recent action, the Commission charged eighteen Sterling Foster brokers with fraudulent sales practices and manipulating the prices of microcap securities. The U.S. Attorney for the Southern District of New York also indicted four of the defendants on related criminal charges.

In another example of the use of the Internet to commit microcap fraud, the Commission charged three current and one former Washington, D.C.-area law students and a Colorado Springs, Colorado city councilwoman with using a stock recommendation web site, Fast-Trades.com, to manipulate the price of four low-priced, thinly traded stocks during February and March 1999. The Commission alleged that Douglas Colt and the other scheme participants purchased their selected stocks before recommending the stocks to thousands of subscribers. Within a few hours of the recommendations, and after the buying momentum by Fast-trades.com subscribers had moved the stocks' prices, the Fast-Trades participants dumped their shares at a profit.

Due to additional appropriations from Congress, we have been able to expand our staff fighting Internet fraud. An additional \$12.5 million in appropriations during the fall of 1999 has allowed the Division of Enforcement to create 75 new staff slots to fight Internet fraud.

In addition, the Divisions of Enforcement, Corporation Finance, and Market Regulation have created an "Early Intervention" program designed to halt potential violations in the early stages without the need for enforcement action. When it appears to the staff that an online unregistered offering is taking place, no exemption from registration is available, and no clear indicia of fraud are present, the staff will send a letter to the offeror, noting that a violation may be taking place and requesting the offeror to voluntarily comply with the Securities Act's registration provisions. The staff has sent 165 letters to various issuers as part of the early intervention program, which has resulted in shutting down more than one-half of the web sites without any further action. When it appears that an unregistered broker-dealer is selling securities online, the staff will also send a letter to the entity, noting a potential violation.

IV. CONCLUSION

Combating microcap fraud continues to be a high priority for the Commission and the SROs. We will continue working to further our efforts to protect investors. Since the Internet has proven to be a conducive medium for this type of fraud, our Internet efforts will likely be an integral segment of our microcap program. The accomplishments and ongoing efforts discussed in the GAO Report and above reflect this commitment.