



THE CHAIRMAN

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

March 31, 1999

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
United States House of Representatives
2322 Rayburn House Office Building
Washington, D.C. 20515-6115

Dear Congressman Dingell:

Enclosed is a memorandum that responds to your letter dated October 14, 1998, pertaining to 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 address your questions regarding progress on the outstanding GAO recommendations.

Combating microcap fraud continues to be a high priority for the Commission and the SROs. The accomplishments and ongoing efforts discussed in the GAO Report and our attached memorandum reflect this commitment. We look forward to working with you on our continued efforts in this important area of investor protection.

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 read "Arthur Levitt".

Arthur Levitt

Enclosure

MEMORANDUM

TO: Arthur Levitt, Chairman

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

DATE: March 31, 1999

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 from the Securities and Exchange Commission's (SEC) progress in addressing General Accounting Office (GAO) recommendations regarding efforts to combat fraud involving microcap stocks.

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 self-regulatory organization (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 have 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 described below, the SEC and SROs have been working to address these areas. 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 study 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 (1) 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; and (2) determine whether legislation or additional reciprocal agreements between the SEC and other financial regulators are necessary to prevent the migration of unscrupulous brokers to other financial services industries.

In 1996, the Commission staff met with representatives from the National Association of Securities Dealers (NASD), the North American Securities Administrators Association, Inc. (NASAA), and the National Association of Insurance Commissioners (NAIC), to discuss steps that could be taken to stem the migration of unscrupulous brokers. At that meeting, it was agreed that an important first step would be to complete the CRD modernization project (see discussion below on status of CRD). The participants also discussed ways for additional regulatory authorities to obtain access to the insurance industry's Producer Database (PDB).¹ It is expected that the CRD modernization program and other avenues of information sharing between federal and state securities, insurance and banking regulators, intended to address the possible migration of unscrupulous brokers, will be discussed at the upcoming Conference held by NASAA and the Commission on Federal-State Securities Regulation.² Although the migration of unscrupulous brokers within the financial services industry has been discussed at previous conferences, the CRD modernization has been the primary focus.

Concerns, analogous to those raised by the GAO, may also arise in connection with the migration of unscrupulous persons from the banking and insurance sector 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

¹ PDB, which provides information on "producers" (the collective industry term for both insurance agents and insurance brokers), can be accessed through the Internet and offers demographic license summary information, certification and clearances, regulatory actions and NASD examination information. Only insurance companies can currently access the PDB, with the payment of a fee. Twenty states currently contribute to the PDB, representing over 1.8 million producers.

² The next meeting is scheduled for April 19, 1999. These annual conferences are intended to carry out the policies and purposes of section 19(c) of the Securities Act of 1933, adopted as part of the Small Business Investment Incentive Act of 1980, to increase uniformity in matters concerning state and federal regulation of securities, to maximize the effectiveness of securities regulation in promoting investor protection, and to reduce burdens on capital formation through increased cooperation between the Commission and the state securities regulatory authorities.

banking agencies,³ from entering the securities industry. It would be helpful to amend the Securities Exchange Act of 1934 (Exchange Act), to make persons subject to a “statutory disqualification”⁴ 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.

2. Reporting and Trend Analysis of Violations Found in Examinations

The GAO Report reiterates a 1991 recommendation that the SEC explore ways to record and maintain information on the number of each type of violation found during on-site examinations of broker-dealers and include this information in its examination tracking system. Staff from our Office of Compliance Inspections and Examinations (OCIE), in conjunction with the Office of Information Technology, are working to develop an examination tracking system to replace its current broker-dealer examination tracking system by FY 2000. In May 1998, a *requirements analysis* was completed for a new examination tracking system called the Super Tracking and Reporting System (STARS). System development began in the fall of 1998. As of this date, STARS has been deployed for testing in OCIE and selected regional offices. As a tool for identifying and analyzing trends in violations, STARS will enable home and regional office staff to make *ad hoc* queries of the database and will interface with other Commission databases. For instance, SEC staff will be able to query the number of firms within the State of New York that have been cited in examinations for books and records violations or fraudulent conduct.

The GAO Report notes that STARS will not be designed to capture data on the number of times each type of rule violation occurred (*e.g.*, the number of trades, records, or accounts). The staff believes that quantifying the number of times a violation is documented in examinations of broker-dealers would add complexity in operating STARS without enhancing the staff’s ability to analyze trends in violations. Reviewing the number of times violations are found at different firms may not yield comparable data because sample sizes and review periods vary in every examination, depending on the firm’s business, size, and compliance history. More meaningful indicators of the significance and extent of violations are the monetary value and the period over which violations occurred, but only when viewed in the context of all the relevant facts and circumstances. Therefore, the staff believes that this information cannot be reduced to a statistical summary. However, in order to gather more information about the significance and extent of violations found in examinations, OCIE is storing the full text of all current reports on the *Zyindex* system. This system enables the staff to conduct searches of all reports using keywords and to compile an analysis of the information.

³ These would include the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision.

⁴ See Exchange Act Section 3(a)(39).

The GAO Report concluded that if STARS and the Zyindex system are implemented as described, these enhanced capabilities would be consistent with GAO's recommendation that the SEC be able to analyze, across firms, trends in violations found during our examinations of broker-dealers. See GAO Report at p. 24.

3. Central Registration Depository

The GAO Report notes that efforts to incorporate technological improvements have delayed the redesign of the CRD system. The NASD, together with the SEC, NASAA and industry representatives, meet regularly to discuss the modernization of the CRD system. The NASD has made significant efforts to involve users in the design and functionality of the CRD. It sought participation from industry, other SROs, state regulators and the SEC on a wide range of issues, from defining system requirements to reviewing system prototypes. The NASD has held regular meetings among policy groups, technology departments, and registration managers. Presentations on CRD are included in NASD Regulation Conferences, as well as special CRD/Public Disclosure Conferences. Although the upgrades to the CRD are not yet complete, the NASD has made reasonable progress and is devoting significant resources to the project. The NASD has made a substantial investment in technology and development for the modernized CRD.

Congressman Dingell requested that the SEC require the NASD to submit quarterly reports on the status of the CRD modernization effort. The NASD submitted its first quarterly report in February 1999. The following comments are based on an analysis of that report and our discussions with the NASD.

The modernized system (Web CRD) will provide a host of enhancements, from improved registration and relicensing to electronic form filing. Electronic form filing is scheduled for implementation in August of this year. In addition to electronic filing, Web CRD will employ a number of completeness checks to alert firms that information necessary for processing their filing is missing before the filing is submitted to the CRD. Costly registration delays resulting from deficient filings will be substantially reduced.

In the past year, NASAA, NASD, the SEC and others have worked together to modify the Forms U-4, U-5 and BD in order to accommodate electronic filing. The NASD has submitted, and the Commission is currently reviewing, a rule proposal to modify Forms U-4 and U-5. The NASD proposes additional formatting and technical changes to the forms in order to fully implement Web CRD. The Commission is also considering revisions to Form BD to accommodate electronic filing.

The regulatory community, including the SEC, state regulators, and the SROs will also benefit this year from the implementation of other key components of the modernized system. On a limited basis, in Fall 1999, regulators will be notified of key filing events that occur in CRD. For example, a notification will be sent to regulators when a firm has changed its business activities, as disclosed on Form BD. Web CRD is expected to allow regulators to conduct various searches of the database for registered representatives or

broker-dealers that meet certain criteria. For example, a search could be done for all registered representatives who have filed for bankruptcy.

In 1998, the SEC approved a rule proposal expanding the NASD's public disclosure program to allow them to respond to electronic inquiries, as well as written or telephone inquiries. This allowed investors to go to NASDR's Internet web site at <http://www.nasdr.com> and request information on any currently registered individual or broker-dealer. Information about a broker's registration is immediately available for viewing. Disciplinary information is available through either the toll-free hotline, or by requesting an e-mail report on the NASDR web page.

The NASD has recently delayed their plans to display disciplinary information on the web page because of concerns regarding immunity in state law defamation cases. NASD is concerned that they are not protected from possible lawsuits by brokers who feel they may be damaged by information posted on the web. Section 15A(i) of the Exchange Act provides that the NASD shall not be liable under state law to any person for information it provides to investors over the telephone. Concerns have been raised that this section may not protect the NASD for information it discloses over its Internet web site. Therefore, as we have discussed with Congressman Dingell's staff, the NASD believes that an amendment to the Exchange Act, expressly allowing disclosure over the Internet, is necessary to implement these disclosures.

The NASD reports that Web CRD's design and development will be Y2K compliant. Certification of the application is scheduled to begin in April 1999. A re-certification will occur prior to August to account for any software changes that might occur after the April certification process. The NASD reported that Web CRD provides a comprehensive and effective set of security measures that ensure: (1) only authorized users gain access to the systems; (2) users perform only the functions for which they are entitled; (3) users obtain and modify only data to which they are entitled; and (4) users' activities in the system are protected from detection and manipulation by others.

Generally, we think that the decision by the NASD in 1997 to reassess the redesign of the CRD and the subsequent decision to use web-based technology was the correct course of action, even though it caused significant delays. The original redesign concept would not have allowed the expanded regulatory and disclosure functions that are part of the newer modernization system. The NASD has met its key deadlines. For example, in 1998 the NASD's public disclosure program became available on the NASDR web page. This year they are currently on target to conduct an industry wide test of the system, involving firms, SROs, state regulators, and the SEC. In addition, the NASD is preparing for a two-week transition period in August of this year to initiate electronic filing. By mid 2000, the NASD intends to finalize enhancements of the administrative and regulatory tools that will be available in Web CRD. We intend to continue to work closely with the NASD to ensure that it meets its commitment to regulators, the industry, and the public to provide a system that is workable and effective.

4. Disclosure of Disciplinary History

In 1994, the SEC's Large Firm Report recommended that information on the availability of a broker's disciplinary history through the NASD's toll-free hotline be disclosed to investors before any activity occurs in their accounts. It is important to note that this recommendation was made before there were other means of making disclosure widely available, such as through the Internet. In 1996, the GAO issued a report of its review of the NASD's Public Disclosure Program (PDP). The report included a recommendation that the NASD publicize and educate investors about the availability of information through the NASD's PDP.

Subsequently, the SEC approved NASD Rule 2280, which requires certain NASD members to provide to customers in writing, at least annually, information on the availability of broker disciplinary information through the NASD's toll-free hotline along with the Internet web site address of the NASD's PDP, and a statement regarding the availability of an investor brochure describing the PDP. The NASD's rule filing 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, the NASD's approach seems to be a reasonable method of disseminating this information.

III. OTHER ACTIONS

The SEC is engaged in a four-pronged approach to combating microcap fraud, involving enforcement, inspections, education, and regulation. We are taking a variety of actions in addition to those included in the GAO recommendations. Many of these initiatives are noted in the Appendix to the GAO Report. The following is an update on actions since the GAO Report was issued.

- **Regulatory**

Rule 504 is the limited offering exemption designed to aid small businesses in raising seed capital without complying with 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).

Form S-8 is a short form used to register the offer and sale of securities to an issuer's employees. The SEC adopted amendments to Form S-8 that are designed to deter abuse of the form to issuing securities in capital raising transactions and to issue securities as compensation to stock promoters. See Securities Act Release No. 7646 (February 25, 1999). Also proposed were additional amendments to Form S-8 designed to further deter abuse. See Securities Act Release No. 7647 (February 25, 1999).

The SEC also recently published notice of the NASD's rule filings to amend its Rules 2315 and 6740 to require brokers to review current financial statements information about an over-the-counter (OTC) issuer before recommending its securities to customers.

The SEC also approved amendments to NASD Rules 6530 and 6540 on January 4, 1999. The amendment to Rule 6530 limits quotations on the OTC Bulletin Board (OTCBB) to the securities of issuers that are current in their reports filed with the Commission or other regulatory authority. The amendment to Rule 6540 prohibits a member from quoting a security on the OTCBB unless the issuer is current in its filing obligations with the Commission. This rule will be phased in over the next eighteen months.

In February 1999, the SEC repropoed amendments to Rule 15c2-11 to deter fraud in the OTC market by increasing the amount of information available to brokers and investors. See Securities 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. These repropoed amendments focus on microcap securities.

The staff is also working with the securities industry to develop other measures to reduce microcap fraud. For example, based on a suggestion by SEC staff, an industry group including the Securities Industry Association, the National Securities Clearing Corporation (NSCC), and others are discussing a plan whereby the NSCC would gather data from a variety of sources on potentially suspicious activity by broker-dealers and their customers, and forward this information to regulators.

- 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. In addition, because they are more likely to report wrong-doing to the SEC and their state securities regulators, educated investors serve as an important early warning system to help regulators fight fraud.

Over the past 18 months, the SEC has issued 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, *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; and

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 Internet web site at <<http://www.sec.gov>>.

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" page on our Internet Web site, and the media. For example, in the past 5 years, we've participated in 28 investors' town meetings across the country, educating investors on how to invest wisely and responding to their concerns. In the spring of 1998, the SEC and a partnership of more than 40 state and federal agencies, consumer organizations, and financial industry associations launched the "Facts on Saving and Investing Campaign," which aims to motivate Americans to get the facts they need to save, invest, and avoid financial fraud. 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.

- Enforcement

The SEC has recently taken an aggressive approach to combating microcap fraud, focusing on early intervention, nationwide enforcement sweeps, and stepped up collaboration with criminal law enforcement authorities. In January and February 1999, the SEC imposed trading suspensions in fourteen microcap securities when adequate and accurate information was not available to investors. In September 1998, the SEC conducted a nationwide microcap sweep, resulting in thirteen actions against forty-one defendants involved in schemes that generated over \$25 million in illegal profits. In October 1998, the SEC conducted the first nationwide crackdown on Internet securities fraud, targeting on-line promoters of microcap stocks who failed to disclose that they had received cash and stock compensation for their promotional efforts. This sweep resulted in the filing of twenty-three enforcement actions against forty-four individuals and companies. In February 1999, the SEC continued this sweep with four more enforcement actions against thirteen individuals and companies across the country. These sweep cases involved a range of illicit Internet conduct, including fraudulent spams (Internet junk mail), on-line newsletters, message board postings and web sites unlawfully touting more than 291 microcap companies.

The SEC has stepped up its collaboration with criminal authorities to conduct parallel criminal and civil investigations of microcap fraud. In 1998, the SEC assisted in an undercover sting operation conducted jointly by the Office of the U.S. Attorney for the Southern District of New York and the FBI, with assistance also from the NASD. This

undercover sting operation resulted in SEC enforcement actions against a total of eighty-seven defendants, three guilty pleas obtained by the U.S. Attorney, and five convictions at trial. The involvement of criminal law enforcement in microcap investigations sends the clear message to microcap fraudsters that the consequence of their misconduct will be more than a mere cost of doing business.

IV. CONCLUSION

Combating microcap fraud continues to be a high priority for the Commission and the SROs. We will continue working on all four prongs 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.



U.S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 942-0020

News
Release

For Immediate Release

99-21

SEC Approves Series of Measures in Ongoing Fight Against Microcap Fraud

Washington, DC, February 19, 1999 -- In its continuing fight against microcap stock fraud, the Securities and Exchange Commission today approved a series of regulatory measures that will provide additional investor protections while fostering the capital formation process. The Commission also issued a new investor education brochure that offers tips on how to detect and avoid microcap fraud.

Taken individually, these targeted measures will increase the amount of information available to brokers and investors, close avenues that allow "pump and dump" schemes, and reaffirm the important role that investors play in protecting themselves.

Chairman Arthur Levitt said, "As more and more first time investors enter the markets and the Internet plays a greater role in people's investment decisions, the Commission continues to be vigilant in the fight against microcap fraud. Today's regulatory measures will take a bite out of microcap fraud, but investors must be a part of the solution by doing their homework, asking the hard questions, and being skeptical, especially of get-rich-quick offers they see on the Internet and elsewhere."

In February of 1998 the Commission began a comprehensive and coordinated effort to fight microcap fraud. This four-pronged effort, which includes enforcement, inspections, education and regulation, has been quite successful, yielding dozens of enforcement actions and better educated investors.

The five actions taken today by the Commission:

- Rule 504 -- Adopted amendments to Rule 504 of Regulation D that will deter microcap fraud while preserving the ability of legitimate small businesses to raise capital. Rule 504 is the limited offering exemption designed to aid small businesses raise seed capital;
- Form S-8 -- Adopted amendments to Form S-8 that will deter abuse by issuers who have shown the greatest inclination to abuse the form in the past, as well as other amendments to facilitate other intra-family transfers of securities. Also proposed additional amendments to further deter abuse. Form S-8 is a short form used to register the offer and sale of securities to an issuer's employees;
- Rule 15c2-11 -- Re-proposed amendments to Rule 15c2-11 to deter fraud in the over-the-counter market by increasing the amount of information available to brokers and investors. This rule governs the publication of quotations for securities in a medium other than a national securities exchange or the Nasdaq, such as the Bulletin Board and Pink Sheets;

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Microcap Rulemaking News Release

February 19, 1999

Page 2

- Rule 701 -- Adopted amendments to Rule 701 to make the rule more useful and eliminate unnecessary restrictions, while preserving the protections to investors. Rule 701 allows private companies to distribute securities to their employees without filing a registration statement;
- Investor Brochure -- The Commission also released a new investor education brochure called "Microcap Stock: A Guide for Investors." The brochure, available on the Commission's website at www.sec.gov, is a primer on the world of microcap stocks and offers a variety of tips on how to detect and avoid microcap fraud. The brochure is also available in a printed booklet; to order, call (800) SEC-0330.

Nancy Smith, Director of the SEC's Office of Investor Education and Assistance, said, "While the Commission is doing all it can to detect and punish microcap scam artists, at the heart of investor protection is an educated investor. Our new booklet, 'Microcap Stock: A Guide for Investors' is a helpful 'how to' kit on understanding the microcap market, investing wisely and avoiding scams. It's a must-read for all microcap investors."

Details on the regulatory measures approved today are available at: www.sec.gov.

For more information about the SEC's four-pronged response to microcap fraud, visit the SEC's Microcap Fraud Information Center at <http://www.sec.gov/news/extra/microcap.htm>.

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**Statement of
Chairman Arthur Levitt
Open Commission Meeting
February 19, 1999**

Good morning. Today, this Commission takes a determined step forward to combat fraud and manipulation in the area of "microcap" securities. It is part of an important, far-reaching campaign to help stamp out dangerous and abusive practices in the trading and selling of low-priced stocks.

Microcap securities provide legitimate opportunities for small and new businesses to raise capital. Unfortunately, they also give the unscrupulous greater license to prey on innocent investors. The reason is straight forward: information about smaller companies is much more difficult to find and obtain than information about larger companies. And, when reliable information is scarce, the potential for fraud increases.

High-pressure cold calling, unauthorized trading in a customer's account, and stock manipulation schemes provide the means to cheat investors out of their life-savings. The Commission has undertaken a four-pronged approach to address this behavior.

First, we have intensified examinations and inspections of broker-dealers who trade in microcap securities. Second, we have increased the coordination of enforcement efforts with law-enforcement, the states and self-regulatory organizations. Third, we have implemented and continue to propose regulations to strengthen disclosure and regulatory oversight of low-priced stocks that trade in low volumes. And fourth, we have dramatically stepped-up our efforts to inform investors on what practical steps they can take to spot securities fraud.

Today's measures represent the last two areas -- regulatory oversight and investor education. Taken individually, these targeted measures will increase the amount of information available to investors, close avenues which have been exploited by some to ruthlessly and irresponsibly promote a certain stock, and reaffirm the important role that investors play in protecting themselves.

In undertaking this action, we are sensitive to any inadvertent impact it may have on the liquidity of thinly traded issues. And, I believe we are striking a balance between capital formation and investor information. This agency's mandate is to protect investors -- and stronger regulation in this segment of the market is essential to fulfilling that mission.

Teddy Roosevelt, nearly a hundred years ago stated, "We draw the line against misconduct, not against wealth." Our efforts to combat microcap fraud is a further demarcation of that line.

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There are few undeniable truths when it comes to investing in our markets. But surely one is that the best, most effective protection an investor can provide for himself is awareness. No amount of regulation -- however omnipotent or ubiquitous -- will completely replace an individual investor's power to ask questions and demand truthful answers.

In that vein, the Commission is doing everything it can to give investors the tools they need to make informed investment decisions. In addition to the regulatory initiatives taken today, we are also releasing a new investor education brochure giving investors tips on how to detect and avoid microcap fraud.

Every day, more and more Americans are investing in our markets. They invest in the hope they will be able to own a house someday, or send their child to college or retire comfortably so they won't be a burden on their families. Dishonest dealers not only undermine public confidence in the integrity of our markets, they damage the hopes and dreams of thousands of hard-working families.

Before I conclude, I want to acknowledge the staff from the Divisions of Corporation Finance, Enforcement, Market Regulation and the Office of Investor Education and Assistance for their work. These measures reflect a thoughtful effort and I thank them for their teamwork.

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Adoption of Amendments to Rule 504
Fact Sheet
2/19/99

Rule 504, the limited offering exemption under Regulation D, is designed to help small businesses raise "seed capital." Currently, Rule 504 permits non-reporting issuers to offer and sell securities to an unlimited number of persons without regard to their sophistication or experience and without delivery of any specified information. General solicitation and advertising are permitted for all Rule 504 offerings. The aggregate offering price of this exemption is limited to \$1 million in any 12-month period, and certain other offerings must be aggregated with the Rule 504 offering in determining the available sales amount. Securities sold under this exemption may be resold freely by non-affiliates of the issuer.

While Regulation D offerings are exempt from federal securities registration requirements, currently these offerings must be registered in each state in which they are offered unless a state exemption is available. The vast majority of states require registration of public Rule 504 offerings. In adopting Rule 504 in 1982, the Commission placed substantial reliance upon state securities laws, since the size and local nature of these small offerings did not appear to warrant imposing extensive federal regulation. These offerings, however, continue to be subject to federal liability and civil liability provisions.

Unfortunately, since adoption of certain revisions to Rule 504 in 1992, there have been some recent disturbing developments in the secondary markets for some securities initially issued under Rule 504, and to a lesser degree, in the initial Rule 504 issuances themselves. These offerings generally involve the securities of "microcap" companies. Recent market innovations and technological changes, most notably, the Internet, have created the possibility of nation-wide Rule 504 offerings for securities of non-reporting companies that were once thought to be sold locally.

In some cases, Rule 504 has been used in fraudulent schemes to make prearranged "sales" of securities under the rule to nominees in states that do not have registration or prospectus delivery requirements. As a part of this arrangement, these securities are then placed with broker-dealers who use cold-calling techniques to sell the securities at ever-increasing prices to unknowing investors. When their inventory of shares is exhausted, these firms permit the artificial market demand created to collapse, and investors, lose much, if not all, of their investment. This scheme is sometimes colloquially referred to as "pump and dump."

The Commission will consider amendments to Rule 504 to deter these abuses yet preserve the ability of legitimate small businesses to raise capital. These amendments would establish the general principle that securities issued in a Rule 504 transaction, just like the other Regulation D exemptions, would be restricted, and would prohibit general solicitation and general advertising, unless the specified conditions for a public Rule 504 offering are met. These conditions would be:

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- the transactions are registered under a state law requiring public filing and delivery of a substantive disclosure document to investors before sale. For sales to occur in a state without this sort of provision, the transactions must be registered in another state with such a provision and the disclosure document filed in the state must be delivered to all purchasers before sale in both states; or
- the securities are issued under a state law exemption that permits general solicitation and advertising, so long as sales are made only to accredited investors as that term is defined in Regulation D.

Most Rule 504 offerings are private. Private Rule 504 offerings would still be permitted for up to \$1 million in a 12-month period, under the same terms and conditions, except for the specific disclosure requirements, as offerings under Rules 505 and 506. Securities in these offerings would be restricted, and these offerings would no longer involve general solicitation and advertising.

However, the amendments to Rule 504 would leave avenues open for issuers to make less limited offerings. By focusing on state registration, review and disclosure requirements, which are generally comprehensive, legitimate small issuers could continue to access the capital markets without having to sell restricted securities.

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Adoption of Amendments to Form S-8
Information Sheet
2/19/99

Form S-8 is the short-form Securities Act registration statement for offers and sales of securities to employees. Unlike other Securities Act registration forms, Form S-8 does not contain a separate disclosure document called a "prospectus." Instead, Form S-8 relies on documents otherwise provided by the employer to satisfy the disclosure obligations of the Securities Act. This abbreviated disclosure is available for offers and sales of securities to employees because of the compensatory nature of these offerings and employees' familiarity with the company's business due to the employment relationship. In 1990, the Commission expanded the employee concept to permit Form S-8 to be used for offers and sales to consultants or advisors who provide legitimate services to the issuer that do not involve the offer or sale of securities in a capital-raising transaction.

Since adoption of the 1990 revisions, some companies have used Form S-8 improperly to compensate consultants whose service to the company is promotion of the company's securities. This practice has been used in fraudulent promotions of microcap securities. In other cases, Form S-8 has been used to distribute securities to public investors through so-called "consultants" whose service to the issuer is selling the securities. This practice, which deprives public investors of the benefits of Securities Act registration, has been the subject of several Commission enforcement actions. The Commission will consider adopting amendments to Form S-8 and related rules designed to deter these abuses. These amendments would:

- amend Form S-8 and related rules to make the form unavailable for sales to consultants and advisors who directly or indirectly promote or maintain a market for the company's securities; and
- amend Securities Act rules so that registration statements, such as Form S-8, that "go effective" automatically upon filing will not be presumed to be filed on the proper form.

The Commission also will consider proposing new amendments to Form S-8 that are designed to deter the same abuses. These proposals would amend the Form S-8 eligibility standards to:

- require any company to be timely in its Exchange Act reports during the 12 calendar months and any portion of a month before the Form S-8 is filed; and
- require a company formed by a merger of a nonpublic company into an Exchange Act reporting "shell" company to wait until it has filed an Exchange Act annual report containing audited financial statements reflecting the merger before filing a Form S-8.

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The Commission continues to consider an earlier proposal to require disclosure in Form S-8 of the names of any consultants and advisors who will receive securities under the registration statement, as well as the amount of securities to be offered to each and the nature of the consulting or advisory services, and related comment requests. The Commission has extended the comment period on these matters for the duration of the comment period on the new proposals. In the future, the Commission may adopt any combination of the earlier proposal, the related comment requests, and the new proposals.

Although Form S-8 has been misused in microcap fraud schemes, most Forms S-8 are filed for legitimate employee compensation purposes. The Commission also will consider adopting amendments that would simplify registration of securities underlying employee benefit plan stock options. Because these options have become an increasingly important component of employee compensation, employees are more likely to face circumstances - such as estate planning and property settlements in connection with divorce - that may require the transfer of options to their family members. Form S-8 appears suitable for the exercise of employee benefit plan stock options by employees' family members because of the continuing compensatory nature of the transaction. The amendments would make Form S-8 available for these exercises, and clarify how options that have been transferred to family members should be disclosed in SEC filings.

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Adoption of Amendments to Rule 701
Fact Sheet
2/19/99

In 1988, the Commission adopted Rule 701 under the Securities Act of 1933 to allow private companies to sell securities to their employees without the need to file a registration statement, as public companies do. The rule provides an exemption from the registration requirements of the Securities Act for offers and sales of securities under certain compensatory benefit plans or written agreements relating to compensation. The exemptive scope covers securities offered or sold under a plan or agreement between a non-reporting ("private") company (or its parents or majority-owned subsidiaries) and the company's employees, officers, directors, partners, trustees, consultants and advisors. The maximum extent of the Commission's authority under Section 3(b) of the Securities Act was used to exempt offers and sales of up to \$5 million per year.

Currently, the amount of securities subject to outstanding offers in reliance on Rule 701, plus the amount of securities offered or sold under the rule in the preceding 12 months, may not exceed the greatest of \$500,000, or an amount determined under one of two different formulas. One formula limits the amount to 15% of the issuer's total assets measured at the end of the issuer's last fiscal year. The other formula restricts the amount to no more than 15% of the outstanding securities of the class being offered. Regardless of the formula elected, Rule 701 restricts the aggregate offering price of securities subject to outstanding offers and the amount sold in the preceding 12 months to no more than \$5 million.

In October 1996, Congress enacted the National Securities Markets Improvement Act of 1996 which, for the first time, gave the authority to provide exemptive relief in excess of \$5 million for transactions such as these. In February 1998, the Commission proposed a number of revisions to increase the flexibility and usefulness of Rule 701, as well as to simplify and clarify the rule.

Today, the Commission will consider revisions to the rule that:

- (1) remove the \$5 million aggregate offering price ceiling and, instead, set the maximum amount of securities that may be sold in a year at the greatest of:
 - \$1 million (rather than the current \$500,000);
 - 15% of the issuer's total assets; or
 - 15% of the outstanding securities of that class;
- (2) require the issuer to provide specific disclosure to each purchaser of securities if more than \$5 million worth of securities are to be sold;
- (3) do not count offers for purposes of calculating the available exempted amounts;
- (4) harmonize the definition of consultants and advisors permitted to use the exemption to the narrower definition of Form S-8;
- (5) amend Rule 701 to codify current and more flexible interpretations; and
- (6) simplify the rule by recasting it in plain English.

Reproposal of Amendments to Rule 15c2-11
Fact Sheet
2/19/99

PROBLEM: Quotations can be integral to fraudulent schemes involving microcap securities. Retail brokers “hyping” a microcap security may point to a market maker’s quotation as indicating the security’s value to a potential customer. The Commission is concerned about the role of these quotations because most market makers for unlisted securities may publish quotations without reviewing information about the issuer.

- Microcap securities often are thinly-traded and their issuers have minimal or no assets. Many of these securities trade in the unlisted over-the-counter market, *i.e.*, they are not listed on an exchange or Nasdaq, but are quoted in systems like the NASD’s OTC Bulletin Board or the National Quotation Bureau’s “Pink Sheets”.

RESPONSE: In February, 1998, the Commission proposed amendments to Rule 15c2-11 under the Exchange Act to require all market makers initiating quotations for unlisted securities in a quotation medium to review information about the issuer, and to review updated information annually if they are publishing priced quotations. The Commission is now reproposing amendments that are substantially similar to the original ones, but they will apply to a smaller group of securities -- ones that are more likely to be prone to fraud and manipulation. Also, the reproposal applies primarily to priced quotations. This narrowed scope responds to commenters’ concerns and should reduce compliance costs.

HOW RULE 15c2-11 WORKS NOW: Rule 15c2-11 requires market makers to review basic issuer information prior to publishing quotations for that issuer’s securities. Market makers must have a reasonable basis for believing that the information is accurate and from reliable sources. The Rule describes the kind of information that the broker-dealer must review.

The problem with the current Rule is that once one market maker has published quotations for a security for at least 30 days, other market makers can publish quotations for the security without reviewing any information (*i.e.*, they can “piggyback” onto the quotes of the first market maker). Market makers then can quote indefinitely without reviewing any updated information (unless the Commission suspends trading in the security).

REPROPOSED AMENDMENTS: The reproposed amendments will require market makers to review issuer information before initiating priced quotes for unlisted securities (*i.e.*, “piggybacking” would be eliminated). In short, they will have to “stop, look and listen” before starting to place priced quotes for an unlisted security in a quotation system.

In addition, market makers publishing priced quotations will have to review updated information annually. Market makers will also have to document their review and record information regarding any significant relationships that they have with the issuer or others, including the receipt of

any compensation to make a market. In one respect, the reproposal does not differ from the current Rule; the first market maker to publish a quote, priced or unpriced, will have to review the specified issuer information.

The reproposal also limits the scope of the Rule to securities that are more likely to be targets of microcap fraud. Under the reproposal, market makers quoting the following securities would not have to comply with the Rule:

- securities with a worldwide average daily trading volume value of at least \$100,000 during each of the six full calendar months immediately preceding the date of publication of a quotation, and convertible securities where the underlying security satisfies this threshold;
- securities with a bid price of at least \$50 per share;
- securities of issuers with net tangible assets in excess of \$10,000,000, based on audited financial statements; and
- non-convertible debt, non-participatory preferred stock, and investment grade asset-backed securities.

The Commission also is publishing an Appendix to the reproposal that gives guidance to broker-dealers on their review obligations under the current rule and lists “red flags” that they should look for when reviewing the issuer information under the reproposal if adopted. These red flags should alert market makers to the potential for fraud involving the issuer of the security.

The issuer information that market makers would need to review is readily available for issuers that file periodic reports with the Commission (*i.e.*, reporting companies). For non-reporting companies, market makers would have to obtain more information than Rule 15c2-11 currently requires, including more information about the issuer's insiders, control persons and promoters and about recent significant events involving the issuer. Importantly, market makers will have to provide non-reporting issuer information to customers that request it.

The proposals generally target the unlisted securities market. By requiring all market makers to review issuer information, they may be deterred from becoming knowing or unwitting participants in fraudulent schemes.

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