CLEARY GOTTLIEB

ALERT MEMORANDUM

SEC Significantly Amends Information Review Requirements for Quotations of OTC Securities

September 29, 2020

On September 16, 2020, the Securities and Exchange Commission ("SEC") published a final rule ("Final Rule") amending SEC Rule 15c2-11, which imposes information review requirements before a broker-dealer may publish or submit a quotation for an over-the-counter ("OTC") security.

In particular, the Final Rule emphasizes that an issuer's information be current and publicly available, extends the information review requirements to, and permits reliance upon, qualified interdealer quotation systems ("IDQSs"), limits the availability of certain existing exceptions to the information review requirements, including the "piggyback" exception, and adds additional exceptions for certain securities that are less susceptible to fraud, such as highly liquid securities of well-capitalized issuers. The Final Rule's adopting release also updates existing SEC guidance regarding *how* a broker-dealer evaluates the reliability of information provided by an issuer and whether the information is accurate, including updating relevant "red flags" that may necessitate additional scrutiny, but reinforces that a broker-dealer is *not* generally required to undertake an independent review of an issuer similar to an underwriter in order to fulfill its obligations under the Final Rule.

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Background

Rule 15c2-11, in both its current and amended form, is a prophylactic anti-manipulation rule that restricts the circumstances in which a broker-dealer may publish a quotation for an OTC security. The rule requires broker-dealers to review certain information about an issuer of an OTC security, and have a reasonable basis for believing such information is materially accurate and reliable, before publishing a quotation for that security in a quotation medium, thus limiting the widespread availability of quotations for securities of issuers for which there is little reliable publicly available information. The information a broker-dealer must review to fulfill this obligation depends on the type of issuer. For issuers with disclosure and reporting obligations under federal securities laws, the broker-dealer can generally fulfill its obligations by reviewing the required disclosure documents. For issuers that do not have such disclosure obligations (a "catch-all issuer"), Rule 15c2-11 sets forth a list of information a broker-dealer must collect and review, including basic information about the issuer's business and the issuer's recent financial statements.

Current Rule 15c2-11 also includes certain exceptions to these obligations, including for (i) securities that trade on a national securities exchange, (ii) unsolicited customer orders, (iii) municipal securities, and (iv) the piggyback exception. The piggyback exception permits broker-dealers to submit quotations without information review responsibility where the underlying security has been the subject of quotations on an IDQS for each of at least 12 days within the previous 30 calendar days, with no more than four business days in between a quotation.

Primary Changes from the Existing Rule

The amendments to Rule 15c2-11 generally expand the scope of the rule to encompass additional market participants, place greater emphasis on information about OTC issuers being both current and publicly available, add exceptions for more liquid and highly capitalized issuers and underwritten offerings, and revise the piggyback exception to limit its use in the case of shell companies and delinquent or other issuers that do not make current information publicly available. These changes are discussed more fully below.

— *Qualified interdealer quotation systems.* The information review requirements of Rule 15c2-11 have been expanded to apply to Qualified IDQSs[1] (together with broker-dealers, the "Covered Entities"). A Qualified IDQS must satisfy these requirements before making known to others the quotation of a broker-dealer that is published or submitted for publication. In addition to reviewing the information for accuracy and reliability, the Qualified IDQS must also make a "publicly available determination" that it has fulfilled its information review obligations.

- In a significant change from current Rule 15c2-11, a broker-dealer is permitted to rely upon a Qualified IDQS to satisfy the information review requirements so long as the broker-dealer publishes its quotation within three days of the Qualified IDQS making a publicly available determination.

— *Types of issuer information.* Aside from adding (i) requirements to review information on the identity of company officers and shareholders that own 10% or more of the issuer's equity for catch-all issuers and (ii) a provision tailored to the specific regulatory status and existing disclosure and reporting obligations of a Regulation Crowdfunding issuer, the Final Rule leaves the *types* of documents and information a Covered Entity must review to fulfill its obligations

[1] An "interdealer quotation system" is defined as any system of general circulation to brokers or dealers that regularly disseminates quotations of identified broker-dealers. A "qualified interdealer quotation system" is defined as any interdealer quotation system operating as an alternative trading system under Regulation ATS 17 C.F.R. § 242.300(a) and is not an "exchange" per the exemptions at 17 C.F.R. § § 240.3a1-1(a)(2).

relatively unchanged (such documents and information, "paragraph (b) information").

— *Emphasis on "current" and "publicly available" information*. The Final Rule adopts several amendments that generally require information relied upon by a Covered Entity to be current and publicly available for all types of issuers. These requirements apply to the publication of quotations founded upon review of paragraph (b) information or reliance upon the piggyback exception, subject in the latter case to certain allowance periods for delinquent issuers.

The Final Rule defines "publicly available" to mean being available on EDGAR, the SEC's electronic filing database; on the website of a state or federal agency, a Qualified IDQS, a registered national securities association, an issuer, or a registered broker or dealer; or through an electronic information delivery system that is generally available to the public in the primary trading market of a foreign private issuer. Access may not be restricted by a username, password, fees, or other restraints.

— *Amended exceptions*. The Final Rule limits the availability of the piggyback exception and modifies the unsolicited quotation exception.

- *Piggyback exception*. The Final Rule makes several changes to the piggyback exception. In particular, the Final Rule includes restrictions where the security is issued by a shell company, [2] the security is the subject of a trading suspension order, or the relevant paragraph (b) information is not timely filed or current and publicly available.
  - Broker-dealers may only rely on the piggyback exception for securities of shell companies for 18 months following the initial quotation for such securities.
  - The exception is unavailable for securities that are, or were, the subject of a trading suspension order until 60 days after the order's expiration.
  - Broker-dealers are only permitted to rely on the piggyback exception if an issuer's paragraph (b) information is current and publicly available or timely filed within the timeframes set out in Rule 15c2-11. However, a broker-dealer may nevertheless continue to rely on the piggyback exception for 14 calendar days following a publicly available determination by a Qualified IDQS or registered national securities association that the relevant paragraph (b) information is out of date, or until the issuer provides current and publicly available or filed paragraph (b) information, whichever period is shorter.
  - The Final Rule retains the requirement that there cannot be more than four business days in succession without a quotation, but removes the other continuous quotation requirements.

In his statement accompanying the Final Rule's release, SEC Chairman Jay Clayton highlighted the piggyback exception as one area particularly in need of amendment as it permitted broker-dealers to maintain markets in OTC securities for issuers with no current and publicly available information or, in some cases, that no longer existed. Rather than remove the exception entirely, the Final Rule acknowledges that the piggyback exception serves an important purpose for facilitating liquidity and directly addresses these concerns by requiring

[2] The Final Rule defines a shell company as any issuer, other than a business combination related shell company, as defined in 17 C.F.R. § 230.405, or an asset-backed issuer as defined in Regulation AB, 17 C.F.R. § 229.1101(b), that has (i) no or nominal operations, and (ii) no or nominal assets, assets consisting solely of cash and cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets.

that, outside the brief grace period noted above, an issuer's paragraph (b) information remain current and publicly available.

- *Unsolicited quotation exception.* The Final Rule modifies the existing exception for unsolicited quotations (*i.e.*, indications of interest) to prohibit use of the exception for quotations on behalf of an affiliate of the issuer or a company insider if the issuer's information is not current and publicly available.

These amendments are intended to help prevent the potential misuse of the exception by company insiders who might create the appearance of an active market in OTC securities to entice new investors to invest, or to facilitate pump-and-dump schemes. Covered Entities may rely on written representations from a customer (or a customer's broker where there is not a direct relationship between the broker-dealer and customer) that he/she is not an insider or an affiliate of the issuer.

— *New Exceptions.* The Final Rule also adds exceptions for highly liquid securities and for underwriters in registered and Regulation A offerings.

- *ADTV and asset test exception.* The Final Rule excepts from the information review requirements (i) a security with a worldwide average daily trading volume value ("ADTV") of at least $100,000 during the 60 calendar days immediately before the publication of a quotation for such security, and (ii) the issuer of such security has at least $50 million in total assets and $10 million in unaffiliated shareholders' equity as reflected in the issuer's publicly available audited balance sheet issued within six months after the end of its most recent fiscal year.

A Covered Entity must satisfy the ADTV value prong of the test with reference to publicly available information (*i.e.*, trading volume as reported by a self-regulatory organization or comparable entity, or an electronic information system that regularly provides information regarding securities in markets around the world). The adopting release also notes that a Covered Entity may not be able to rely on the ADTV and asset test exception where the issuer finds a mistake in its financial statements such that they cannot be relied upon. However, the requirement that such financial statements be audited should somewhat alleviate such risk.

- *Underwritten offering exception.* The Final Rule allows a broker-dealer, without complying with the information review requirement, to publish or submit a quotation for a security of the same class issued in an underwritten offering if the broker-dealer served as the underwriter, so long as the broker-dealer's quotation is published or submitted within the specified time frame.[3]

— *Publicly available determinations.* A broker-dealer may rely on a publicly available determination by a Qualified IDQS or a registered national securities association that certain exceptions are available or that the Qualified IDQS complied with its information review requirement, rather than undertake its own review. In particular, the Final Rule allows a broker-dealer to rely on determinations by a Qualified IDQS or registered national securities association that the exchange-traded security exception, the piggyback

[3] The applicable time frames are (i) a registration statement that became effective fewer than 90 calendar days before the day on which such broker-dealer publishes or submits the quotation to the quotation medium, for an offering for that class of security, or (ii) an offering statement under Regulation A that was qualified fewer than 40 calendar days before the day on which such broker-dealer publishes or submits the quotation to the quotation medium for an offering of that class of security.

exception, the municipal security exception, or the ADTV and asset test exception are available.

Qualified IDQSs and registered national securities associations that make such publicly available determinations must establish, maintain, and enforce reasonably designed written policies and procedures to determine whether the issuer's information is current and publicly available and that the requirements of the applicable exception for which it has made a publicly available determination are met.

The SEC confirmed that policies and procedures for making publicly available determinations regarding the availability of the piggyback exception must provide for review, *on an ongoing basis*, that an issuer's paragraph (b) information is current, timely filed, and publicly available.

— *Supplemental Information.* The Final Rule maintains the requirement that a Covered Entity must consider and maintain records of certain supplemental information, such as a copy of a trading suspension order issued by the SEC, or any information about the issuer that comes into the Covered Entity's knowledge or possession as part of the Covered Entity's evaluation of whether the paragraph (b) information is materially correct. The Final Rule extends the requirement to require that the Covered Entity also maintain records of whether the person or persons for whom the quotation is submitted are company insiders.

— *Updates to prior SEC guidance and "red flags."* The Final Rule's adopting release also includes minor updates to, combines, and supersedes, prior SEC guidance regarding determining source reliability and the information review requirement.[4]

- The revised guidance reiterates that there is no obligation to conduct an independent due diligence exercise like those undertaken by an underwriter.

Key Takeaways

— *The emphasis on current and publicly available information may reduce the number of issuers with access to the OTC markets*. The Final Rule's requirements that issuers make information publicly available on an ongoing basis may impact the ability of issuers that choose not to undertake the burden of public disclosure to raise capital or maintain the value of preexisting securities. On the other hand, consistent with the SEC's general belief in the importance of disclosure in a functioning marketplace, it may also further incentivize issuers—particularly issuers with active and ongoing operations—to make information available on a continuing basis.

— *The expansion of the Final Rule to include IDQSs, and the ability of broker-dealers to rely on them, will enhance the importance of such platforms in the OTC market.* The central role that the SEC has given Qualified IDQSs in the Final Rule will likely consolidate the collection and review of issuer information and the ability of broker-dealers to rely on an exception to the Final Rule. This will both increase the importance of Qualified IQDSs in the OTC markets and foster consistency in application of the Final Rule.

— *The market for an issuer's security following an initial quotation is likely to be more competitive.* An effect of the ability of broker-dealers to rely on a Qualified IDQS to make a determination under the Final Rule will permit more firms to initiate quotations promptly, rather than waiting for the availability of the piggyback exception or incurring the initial compliance burden or attendant regulatory risk.

— *There is no exception for issuers emerging from reorganization*. The SEC considered, but did not adopt, an exception to the Final Rule that would

[4] We have reproduced those red flags in Attachment 1 to this Alert.

permit quotations in securities for issuers based on filings with a bankruptcy court.

Conclusion

The Final Rule's compliance date is nine months after the effective date of the Final Rule,[5] except that the requirement to review financial information for catch-all issuers for the past two years will not be effective until two years after the effective date in order to permit such information to be made publicly available.

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[5] The effective date is 60 days following publication in the Federal Register. As of the date of this Alert, the Final Rule has not yet been published in the Federal Register.

Attachment 1: Examples of Red Flags

1. *SEC and Foreign Trading Suspensions*. Trading suspensions, including foreign trading suspensions, generally raise significant red flags as to whether the issuer's information is accurate and whether the sources of such information are reliable. Once a trading suspension terminates, and before a broker-dealer can publish a quote, a broker-dealer or Qualified IDQS must comply with the information review requirement if it cannot rely on an exception to Rule 15c2-11. While conducting its information review under the Final Rule following a trading suspension, a broker-dealer or Qualified IDQS may want to attempt to determine the basis for the suspension order and assess whether the issuer information that is current and publicly available following the trading suspension is accurate and whether its source is reliable. Such review may include seeking verification from the issuer or soliciting the views of an independent professional.
2. *Concentration of ownership of the majority of outstanding, freely tradeable stock*. Concentration of ownership of freely tradeable securities is a prominent feature of microcap fraud cases. When one person or group controls the flow of freely tradeable securities, this person or persons can have a much greater ability to manipulate the stock's price than when the securities are widely held.
3. *Large reverse stock splits*. Fraudulent and manipulative activity in OTC securities can involve the substantial concentration of the publicly traded float through a reverse stock split. The subsequent issuance of large amounts of stock to insiders increases their control over both the issuer and trading of the stock.
4. *Companies in which assets are large and revenue is minimal without any explanation*. A red flag exists when the issuer assigns a high value on its financial statements to certain assets, often assets that are unrelated to the company's business and were recently acquired in a non-cash transaction. While assets that are unrelated to the business of the issuer are not always an indication of potential fraud, some unscrupulous issuers have overvalued these types of assets in an effort to inflate their balance sheet. In such situations, the company's revenues often are minimal and there appears to be no valid explanation for such large assets and minimal revenues. Also, a red flag is present when the financial statements of a development stage issuer list as the principal component of the issuer's net worth an asset wholly unrelated to the issuer's line of business.
5. *Shell company's acquisition of private company or other material business development*. Shell companies have been used as vehicles for fraud in a number of different fact patterns and schemes. The piggyback exception under the Final Rule prohibits broker-dealers from relying on the piggyback exception for shell companies after a certain period. The SEC remains concerned about the potential that a continuously quoted market could be used to entice investors to make an investment decision based on what appears to be an active and independent market when, in fact, the investor may be considering the security price of the shell company that increased due to inaccurate and misleading promotional information. A broker-dealer should be mindful of the potential for abuse when reviewing issuer information where a shell company is involved, in particular if the shell company has acquired a privately held company or has undergone other material business developments (including, but not limited to, declarations of bankruptcy, reorganizations and mergers).
6. *A registered or unregistered offering raises proceeds that are used to repay a bridge loan made or arranged by the underwriter where:* (1) the bridge loan was made at a high interest rate for a short period; (2) the underwriter received securities at below market rates prior to the offering; and (3) the issuer has no apparent business purpose for the bridge loan.

7. *Significant write-up of assets upon a company obtaining a patent or trademark for a product.* The significant write-up of assets once an issuer obtains a patent or trademark for a product may be a technique used by issuers engaged in fraud to inflate their balance sheets.
8. *Significant assets consist of substantial amounts of shares in other OTC companies*. Some fraudulent activity may involve issuers whose major assets are substantial amounts of shares in other OTC companies.
9. *Assets acquired for shares of stock when the stock has no market value*. The issuer's financial statements often can indicate that the issuer acquired assets to which it assigned substantial value in exchange for its essentially worthless stock.
10. *Unusual auditing issues*. Examples of this include auditors who refuse to certify financial statements or who issue audited reports containing a qualified opinion, where there has been an unexplained change of accountants, or an accountant has resigned or been dismissed. Rule 15c2-11 does not contemplate that a broker-dealer or Qualified IDQS will scrutinize the issuer's financial statements with the expertise of an accountant. If, however, a broker-dealer or Qualified IDQS sees any of these examples of red flags, it may wish to confirm the auditor's credentials with the appropriate state licensing authority, question the circumstances of the change in accountants, and carefully scrutinize the Final Rule's specified information.
11. *Significant write-up of assets in a business combination of entities under common control or extraordinary items in notes to the financial statements.* Unusual related party transactions are sometimes found in fraud schemes and may be used to write up the value of an issuer's assets after a merger between the related parties.
12. *Suspicious documents*. Examples can include inconsistent financial statements, altered financial statements, and altered certificates of incorporation. Issuer information that is altered on its face raises red flags that, at a minimum, could lead a broker-dealer or Qualified IDQS to determine it does not have a reasonable basis to believe the issuer's information is accurate.
13. *A broker-dealer or Qualified IDQS receives substantially similar offering documents from different issuers with certain characteristics*. Such characteristics include: the same attorney is involved; the same officers and directors are listed; or the same shareholders are listed. If a broker-dealer or Qualified IDQS realizes, after reviewing the information for several issuers, that the same individuals are involved with these entities, the broker-dealer or Qualified IDQS should consider inquiring further to determine whether it has a reasonable basis to believe that the issuer information is accurate.
14. *Extraordinary gains in year-to-year operations*. Such gains may be achieved through assigning an artificially high value to certain assets or through other manipulative devices that are red flags, such as the significant write-up of assets upon merger or acquisition.
15. *Reporting company fails to file an annual report.* A reporting company's failure to file an annual report suggests that there is a potential problem with the company.
16. *Disciplinary actions against an issuer's officers, directors, general partners, promoters, auditors, or control persons*. The following types of disciplinary actions raise red flags: an indictment or conviction in a criminal proceeding; an order permanently or temporarily enjoining, barring, suspending or otherwise limiting an officer, director, general partner, promoter, auditor, or control person's involvement in any type of business, securities, commodities, or banking activities; an adjudication by civil court of competent jurisdiction, the SEC, the Commodity Futures Trading Commission or a state securities regulator of a violation of federal or state securities or commodities law; or an order by a self-regulatory organization permanently or temporarily barring, suspending or otherwise limiting involvement in any type of business or securities activities.

17. *Significant events involving an issuer or its predecessor, or any of its majority owned subsidiaries*. The following types of significant events raise red flags: change in control of the issuer; substantial increase in equity securities; merger, acquisition, or business combination; acquisition or disposition of significant assets; bankruptcy proceedings; or delisting from any securities exchange. These are all examples of significant events involving the issuer, though they are not per se examples that reflect fraud and manipulation. However, certain events—a change in control of the issuer; merger, acquisition, or business combination; or acquisition or disposition of significant assets—can provide unscrupulous issuers an opportunity to artificially overvalue the issuer's assets to support an upward manipulation of the issuer's stock. An increase in the number of an issuer's equity securities provides the securities necessary for such manipulation. Bankruptcy proceedings or delisting from an exchange may also indicate facts surrounding an issuer that could lead a broker-dealer or Qualified IDQS to conclude that it does not have a reasonable basis to believe that the issuer's financial information is accurate.
18. *Request to publish both bid and offer quotes on behalf of a customer for the same stock*. The highly unusual request from a customer for the broker-dealer to publish both bid and offer quotes is a red flag that may indicate manipulative trading (e.g., wash trades) and may call for appropriate inquiry on the part of a broker-dealer or Qualified IDQS.
19. *Issuer or promoter offers to pay a fee*. If a broker-dealer receives an offer from an issuer, any affiliate or promoter thereof, to pay a fee in connection with making a market in the issuer's security, this is both a red flag and a potential FINRA rule violation. Specifically, it is a violation of FINRA Rule 5250 for a broker-dealer or any person associated with a broker-dealer to accept any payment or other consideration, directly or indirectly, from an issuer of a security, or any affiliate or promoter thereof, for publishing a quotation, acting as market maker in a security, or submitting an application in connection therewith.
20. *Regulation S transactions of domestic issuers*. Regulation S provides a safe harbor from the registration requirements of the Securities Act for offers and sales of securities by both foreign and domestic issuers that are made outside the United States. In 1998, the SEC adopted amendments to Regulation S designed to prevent the abuses that relate to offshore offerings of equity securities of domestic issuers, in particular transactions involving large amounts of the securities of U.S. issuers for which little information was available. Broker-dealers and Qualified IDQSs should be alert to any questionable activities involving Regulation S offerings.
21. *Form S-8 stock*. Form S-8 is the short-form registration statement for offers and sales of a company's securities to its employees, including its consultants and advisors.[6]

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[6] In the proposed amendments to Rule 15c2-11 in 1999, the SEC stated that Form S-8 has been abused by unscrupulous issuers to register securities nominally offered and sold to employees or, more commonly, to so-called consultants and advisors. These persons then resell the securities in the public markets, at the direction of the issuer or a promoter. In a typical pattern, an issuer registers on Form S-8 securities underlying options issued to so-called consultants where, by prearrangement, the issuer directs the consultants' exercise of the options and resale of the underlying securities in the public market. The consultants then either remit to the issuer the proceeds from the sale of the underlying shares, or apply the proceeds to pay debts of the issuer that are not related to any services provided by the consultants. In some cases, these consultants perform little or no other service for the issuer. In other microcap frauds, the issuer uses Form S-8 to sell securities to "employees" who act as conduits by selling the securities to the public and remitting the proceeds (or their economic benefit) to the issuer. This public sale of securities by the issuer has not been registered, although the Securities Act requires registration.

22. *"Hot industry" OTC stocks*. Another characteristic of misconduct in the OTC market is that it often can involve stocks that are in vogue.
23. *Unusual activity in brokerage accounts of issuer affiliates, especially involving "related" shareholders*. Fraudulent and manipulative activity in the OTC market can begin with the deposit and sale of large blocks of an obscure stock by a new and unfamiliar customer who often is affiliated with an issuer and a simultaneous request by the issuer that the broker-dealer make a market in the stock.
24. *Companies that frequently change their names or lines of business*. The SEC and other regulators have brought enforcement actions in which this type of activity among OTC issuers has been a characteristic of the alleged misconduct.