Client Alert

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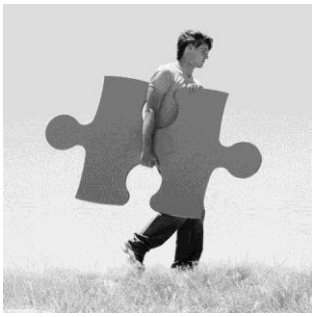

Private Secondary Markets and Rule 15c2-11

SEC Concerns with the "Piggyback" Exception of Rule 15c2-11

Rule 15c2-11 ("Rule 15c2-11") under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), sets forth procedures for the submission and publication of quotations by broker-dealers for certain over-the-counter equity ("OTC") securities. The purpose of Rule 15c2-11 is to prevent fraudulent, deceptive or manipulative acts or practices among broker-dealers in publishing securities quotes for securities that are traded on exchanges other than U.S. national securities exchanges. Rule 15c2-11 requires broker-dealers to review and maintain specified information about the issuer. Speaking in the context of the secondary market for the securities of privately held companies, Luis Aguilar, former Commissioner of the Securities and Exchange Commission (the "SEC"), voiced concern that the "piggyback exception" of Rule 15c2-11 may compromise the integrity of market quotations and hinder the creation of a fair and efficient secondary market by allowing broker-dealers to rely on potentially stale issuer information.[1] Pursuant to this exception, if an OTC security has been quoted during the past 30 calendar days, and during those 30 days the OTC security was quoted on at least 12 days without more than four consecutive business days without quotations, then a subsequent broker-dealer may "piggyback" off of this previous quotation and does not need to meet the requirements of Rule 15c2-11 (which we describe below). The exception assumes that regular and frequent quotations for an OTC security generally reflect market supply and demand and are based on independent and informed decisions, an assumption that has since been challenged. Given that in recent years more and more companies are choosing to remain privately held longer and thus deferring their IPOs and relying on exempt offerings, concerns have arisen with respect to the secondary private markets for the securities of these companies as to which there may be limited information. In recent statements, SEC Chair White expressed some concerns regarding the availability of, and the quality of, information regarding companies that are not Exchange Act-reporting. Chair White also noted that the integrity of secondary markets depended on robust and timely disclosures.

Exempt Offerings and Rule 15c2-11

As mentioned above, the purpose of Rule 15c2-11 is to prevent fraudulent, deceptive or manipulative acts or practices among broker-dealers in the publication of quotations for OTC securities. The protections provided by

[1] *See* speech of Commissioner Luis A. Aguilar titled "The Need for Greater Secondary Market Liquidity for Small Businesses" (Mar. 4, 2015), *available at*: http://www.sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html#_edn32; speech of Commissioner Luis A. Aguilar titled "The Continuing Work of Enhancing Small Business Capital Formation" (Nov. 19, 2015), *available at*: http://www.sec.gov/news/statement/continuing-work-of-enhancing-small-business-capital-formation.html.

Rule 15c2-11 have become increasingly relevant with the adoption of amendments to Regulation A ("Regulation A") and the adoption of Regulation Crowdfunding ("Regulation Crowdfunding") under the Securities Act of 1933, as amended (the "Securities Act").

Regulation A was amended to allow for offerings by smaller companies in a 12-month period, including to non-accredited investors, of up to $20 million for Tier 1 offerings and up to $50 million for Tier 2 offerings (previously the cap was set at $5 million). The securities issued in a Regulation A offering are not restricted securities and thus are freely transferable in the secondary market. Tier 2 offerings also are exempt from state securities law registration and qualification requirements. In addition, the SEC adopted final rules relating to crowdfunding. Regulation Crowdfunding allows for offerings by non-SEC reporting companies of up to $1 million in a 12-month period to non-accredited investors over an Internet-based platform. The securities issued in crowdfunded offerings are restricted securities and subject to certain transfer requirements for a period of one year. These regulations provide more investors, particularly non-accredited investors, an opportunity to invest in exempt offerings. However, there are concerns with adequately protecting investors since issuers of securities under Regulation A and Regulation Crowdfunding cannot be Exchange Act-reporting companies and the securities also are not likely to be listed on a national securities exchange, resulting in less liquidity and transparency in the secondary market.

In connection with the amendments to Regulation A, Rule 15c2-11 was also amended to allow an issuer's ongoing reports filed under a Tier 2 offering to satisfy the specified information required under Rule 15c2-11. With respect to Regulation Crowdfunding, the adopting release clarified that Regulation Crowdfunding does not affect the obligations of broker-dealers under Rule 15c2-11 and directs the SEC staff to re-evaluate Rule 15c2-11 in light of recent market developments. Given interest in the quality and availability of "private company" disclosures, this would seem like an important priority for the SEC.

Requirements under Rule 15c2-11

Rule 15c2-11 provides that it is unlawful to publish any quotation for a security in any quotation medium, including the "OTC Bulletin Board" operated by the Financial Institution Regulatory Authority, Inc. ("FINRA") or the marketplaces (OTCQX, OTCQB and OTC Pink) operated by the OTC Markets Group, unless the broker-dealer complies with the requirements listed below. Depending on the circumstances of the issuer, Rule 15c2-11 may be satisfied in one of the following five ways:

> (1) the broker-dealer must have in its possession a prospectus specified by Section 10(a) of the Securities Act, other than a registration statement on Form F-6, that has been filed with the SEC and which has been in effect less than 90 calendar days;
>
> (2) the broker-dealer must have a copy of the offering circular provided for under Regulation A and the effective date must be within the preceding 40 calendar days;
>
> (3) the issuer must be current in its filings with the SEC, and the broker-dealer must have in its possession the issuer's latest annual report on Form 10-K, all subsequent quarterly reports on Form 10-Q, and those current reports on Form 8-K filed within five business days prior to submission or publication of the quotation;

(4) the issuer must be exempt from Section 12(g) of the Exchange Act pursuant to Rule 12g3-2(b) under the Exchange Act, and the broker-dealer must make reasonably available, upon the request of an interested person, all the information furnished to the SEC during the issuer's last fiscal year; or

(5) the broker-dealer must have in its possession a list of 16 items of information, each of which must be reasonably available upon request by an interested person and be reasonably current in relation to the submission date of the quotation, and the broker-dealer also must provide the required information regarding the issuer and the security to the interdealer quotation system at least three business days before the quotation is published or submitted.

The information required by paragraph (5) above includes, but is not limited to, the following:

- the name of the issuer and any predecessor;
- the address of the issuer's principal executive offices and a description of its facilities;
- the state of incorporation of the issuer;
- information relating to the quoted security;
- the name and address of the transfer agent;
- the nature of the issuer's business, products and services;
- the name of the chief executive officer and members of the board of directors of the issuer;
- recent financial information and financial information of the issuer for the preceding two years;
- and whether the quotation is being published or submitted on behalf of another broker-dealer or on behalf of the issuer, a director, officer or any beneficial owner of more than 10% of the outstanding share capital (if applicable, the basis for an exemption under the federal securities laws for sales on behalf of such person).

In each of paragraphs (1)-(5) above, the broker-dealer must have a reasonable basis for believing that the information obtained is accurate. In addition, the broker-dealer must keep (1) a record of the circumstances surrounding the quotation, including information about any person requesting the quotation; (2) a copy of any trading suspension order (or a copy of the public release announcing the order) issued by the SEC with respect to the issuer's securities pursuant to Section 12(k) of the Exchange Act during the preceding 12 months; and (3) a copy or written record of other material information regarding the issuer known to or in the possession of the broker-dealer prior to submitting or publishing the quotation. This information, along with the information required in paragraphs (1)-(5) above, must be preserved by the broker-dealer for no less than three years.

However, it should be noted that there are some exceptions where Rule 15c2-11 does not apply. These exceptions primarily relate to instances where a broker-dealer seeks to quote a security that (1) is traded on a U.S. national securities exchange, (2) represents unsolicited customer interest, (3) has been the subject of regular and continuous quotations for the past 30 days (i.e., the piggyback exception), or (4) is traded on Nasdaq. Importantly, these exceptions apply to the security, not to the issuer. The SEC also may exempt publications as "not constituting a fraudulent, manipulative or deceptive practice."

Suggested Amendments

Commissioner Aguilar has proposed a few ways Rule 15c2-11 could be amended to better serve small businesses and their investors.[2] First, he suggested eliminating (or amending) the piggyback exception. Second, he suggested requiring broker-dealers that publish quotations to review current information on the issuer on an annual basis to promote accountability. Finally, he proposed enhancing investor access to information so that investors may be better informed.

The SEC previously has proposed amending Rule 15c2-11 on three occasions to address concerns of fraud in the OTC market. The initial proposal, in 1991, would have eliminated the piggyback exception. A subsequent proposal, in 1998, among other things, would have eliminated the piggyback exception by requiring all broker-dealers to review current issuer information before publishing their first quotation for a covered OTC security, without regard to whether the quotation was priced or unpriced, and to thereafter review current issuer information annually if they published priced quotations. Then, in 1999, a third proposal included amendments that would have limited Rule 15c2-11 primarily to priced quotations and would have eliminated the piggyback exception by requiring all broker-dealers to review current issuer information before publishing priced quotations for a security. However, these proposals were never finalized.

Interplay with FINRA Rule 6432

FINRA Rule 6432 requires members of FINRA to comply with Rule 15c2-11. Under FINRA Rule 6432, a member must file the following information on Form 211 with FINRA at least three days prior to publishing or displaying the quote in the quotation medium:

- a copy of the information required under Rule 15c2-1;[3]
- identification of the issuer, the issuer's predecessor in the event of a merger or reorganization within the previous 12 months, the type of non-exchange-listed security to be quoted, the quotation medium to be used, the member's initial or resumed quotation, and the particular subsection of Rule 15c2-11 with which member is in compliance;
- if a member is initiating or resuming quotation of a non-exchange-listed security with a priced entry, the basis upon which that priced entry was determined and the factors considered in making that determination; and
- a certification that neither the member nor persons associated with the member have accepted or will accept any payment or other consideration prohibited by FINRA Rule 5250.

FINRA also has issued guidance regarding compliance with Rule 15c2-11.[4]

As mentioned above, in connection with the adoption of Regulation Crowdfunding, the SEC staff was directed to undertake a study on the impact of the regulation on capital formation and investor protection. The study must consider secondary market trading practices generally, as well as the effectiveness of Rule 15c2-11 in regulating

[2] *See supra* note 1.
[3] Members are not required to file with FINRA copies of any information that is available through the SEC's Electronic Data Gathering, Analysis, and Retrieval ("EDGAR") system; provided, however, that the filing contains identifying information for each report or statement relied upon in satisfying the member's obligations under FINRA Rule 6432 and Rule 15c2-11.
[4] See http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1675&print=1.

these practices. Though there may be changes to Rule 15c2-11 in the interim, the report must be completed no later than three years following the effective date of Regulation Crowdfunding (May 16, 2016). Perhaps this timeline will be accelerated in light of investor protection concerns.

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