

CLIENT ALERT

Rule 15c2-11 Amendments: OTC Market Disruptor?

By Larry E. Bergmann

On September 16, 2020, the Securities and Exchange Commission (“SEC”) adopted extensive amendments to Rule 15c2-11 (“Rule”)¹ under the Securities Exchange Act of 1934 (“Exchange Act”).² The Rule governs the publication of quotations for securities in the over-the-counter (“OTC”) market, which consists largely of smaller companies and retail investors.³ Although the amended Rule becomes effective 60 days after publication in the Federal Register, compliance with the new provisions is not required until 9 months after the effective date to allow market participants and investors to adjust to the new OTC world.⁴

The amendments significantly change the circumstances in which broker-dealers may publish quotations that provide market liquidity for buyers and sellers of OTC securities and make an already complicated rule even more complex. This Client Alert discusses some of the major aspects of the amended Rule, but a complete analysis of its operation is beyond the scope of this summary.

1. THE BASIC RULE

Unless an exception applies, Rule 15c2-11 makes it unlawful for a broker-dealer to initiate a quotation for a security unless the broker-dealer (1) has in its records prescribed information about the issuer and (2) based upon a review of the information, has a reasonable basis for believing that the information is accurate in all material respects and that the sources of the information are reliable.⁵ The specific information required depends upon the regulatory status of the issuer, such as whether the issuer is required to file reports with the SEC or has recently conducted a public offering of its securities.⁶ According to the SEC, “broker-dealers play an integral role in facilitating investor access to OTC securities and serve an important gatekeeper function.”⁷

¹ 17 CFR 240.15c2-11.

² Release 34-89891 (September 26, 2020), <https://www.sec.gov/rules/final/2020/33-10842.pdf> (“Release”).

³ Approximately 10,000 securities were quoted in the OTC markets on an average day in 2019. Release at 219. Quoted OTC securities were valued at approximately \$32.3 trillion in 2019. Id. at 218 n.638.

⁴ Therefore, if Federal Register publication occurs on October 1, 2020, the compliance date would be September 1, 2021. The requirement for 2 years past financial information for a “catch-all issuer” would have a compliance date of October 1, 2022.

⁵ Rule 15c2-11(a)(1).

⁶ Rule 15c2-11(b). This is referred to as the “paragraph (b) information.”

⁷ Release at 6.



The SEC has adopted extensive amendments to Rule 15c2-11 under the Securities Exchange Act of 1934.

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The SEC's primary concern in adopting the Rule amendments is the lack of current and publicly-available information about many issuers whose securities trade on the OTC market.⁸ In the SEC's view, those situations arise frequently because of the "outdated exceptions" to the information-gathering requirements in the pre-amended Rule, principally the so-called "piggyback" exception discussed below.

2. "CURRENT" AND "PUBLICLY AVAILABLE" INFORMATION

Critical to the Rule's operation is issuer information that is current and publicly available. "Current" means that the information is filed, published, or as of a date in accordance with the time frames specified in paragraph (b)(1), (2), (4), or (5), or for paragraph (b)(3) the most recent required annual report or statement (together with subsequently filed reports or statements) for issuers required to file under Exchange Acts Sections 13 or 15(d), Regulation A, Regulation Crowdfunding, or Exchange Act Section 12(g)(2)(G).⁹ "Publicly available" means that the information is available on: the SEC's EDGAR system; on the website of a state or federal agency, a qualified interdealer quotation system (discussed below), a registered national securities association (i.e., the Financial Industry Regulatory Association ("FINRA")), an issuer, or a registered broker-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. Significantly, information is not publicly available where access is restricted by user name, password, fees, or other restraints.¹⁰

3. QUALIFIED INTERDEALER QUOTATION SYSTEM

A major innovation in the amended Rule is the concept and role of a "qualified interdealer quotation system" ("QIDQS").¹¹ In certain circumstances, an QIDQS can perform the information review required by the Rule and make a public determination that the information is current and publicly available. In that situation, broker-dealers can rely on that determination and submit quotations for publication in the QIDQS. No entity is required to become a QIDQS. Although there may be advantages to being a QIDQS, that status comes with significant obligations and responsibilities.¹²

4. EXCEPTIONS TO THE BROKER-DEALER'S INFORMATION GATHERING AND REVIEW REQUIREMENT

Under specified circumstances, a broker-dealer can publish quotations without first reviewing the prescribed information. Indeed, the SEC recognized that the majority of OTC quotations are currently and are expected to continue to be published in reliance on exceptions rather than on the performance of the information review requirement.¹³ The amended Rule significantly alters the way in which a number of the exceptions operate.

a. Unsolicited quotation exception: Rule 15c2-11(f)(2)

This exception generally permits a broker-dealer to publish a quotation that solely reflects a customer's unsolicited indication of interest in purchasing or selling an OTC security. The amended rule qualifies this exception in the case of unsolicited orders from an insider or affiliate of the issuer of the security. In that case, the broker-dealer may not publish a quotation reflecting the insider or affiliate's order unless the paragraph (b) information is current and publicly available. According to the SEC, this condition "helps to prevent misuse of the unsolicited quotation

⁸ Id. at 5 (footnote omitted) ("A lack of current and public information about these companies disadvantages retail investors because it may prevent them from estimating return probabilities and generating positive returns in OTC stocks. It can contribute to incidents of fraud and manipulation by preventing retail investors from being able to counteract misinformation.")

⁹ Rule 15c2-11(e)(2).

¹⁰ Rule 15c2-11(e)(5).

¹¹ Rule 15c2-11(e)(6). A QIDQS is an interdealer quotation system (defined in paragraph (e)(3)) that meets the definition of an "alternative trading system" under Exchange Act Rule 300(a) of Regulation ATS and operates pursuant to the exemption from the definition of "exchange" in Exchange Act Rule 3a1-1(a)(2).

¹² See Rule 15c2-11(a)(2), (a)(3), (f)(3)(ii), (f)(7).

¹³ Release at 53.

exception by company insiders and affiliates who may take advantage of access to information about the company that is not available to non-insiders.”¹⁴

b. “Piggyback” exception: Rule 15c2-11(f)(3)

The changes to the piggyback exception are the most significant alterations to the Rule because, on an average day, approximately 90% of OTC quotations rely on this exception.¹⁵ Of the approximately 10,000 securities quoted OTC in 2019, the SEC estimates that 3,489 will lose piggybacking eligibility as a result of the amendments.¹⁶

As noted above, SEC’s primary concern in adopting the amendments is the lack of current and publicly available information about many issuers whose securities trade on the OTC market.¹⁷ In particular, the SEC focussed on the piggyback provision that allows broker-dealers to continue to publish quotations even if there is no current information about the issuer of the security. The SEC noted that, “[i]n some cases, a quoted market may continue for the securities of issuers that no longer exist or have ceased operations.”¹⁸

In adopting the amendments, the SEC abandoned the basis that had supported the piggyback exception for over 40 years, namely that “regular and continual priced quotations are an appropriate substitute for information about the issuer which would otherwise be relevant in establishing a quotation,” because it does not “adequately take[] account of current industry and investor practices in today’s OTC market, [and does not] sufficiently promote investor protection or the broker-dealer’s role as a gatekeeper to the OTC market.”¹⁹

Most significantly, the piggyback exception now is available only if the paragraph (b) information is filed or available within specified time frames, subject to a potential 15 calendar-day extension.²⁰

The Rule loosens and tightens piggyback availability in other respects.

- The Rule no longer has 12 and 30-day measuring periods for piggyback eligibility. Now, piggybacking may continue unless there is more than four business days in succession without a quotation for the security.²¹
- The exception is no longer available for quotations in an IDQS unless the IDQS specifically identifies as such unsolicited customer indications of interest.²²
- Piggybacking requires at least a one-sided (i.e., a bid or offer) priced quotation.²³
- Piggybacking is not available for 60 calendar days after the expiration of an SEC trading suspension.²⁴

¹⁴ Release at 116-117.

¹⁵ Release at 217-218 n.636.

¹⁶ Release at 258.

¹⁷ Id. at 5 (footnote omitted) (“A lack of current and public information about these companies disadvantages retail investors because it may prevent them from estimating return probabilities and generating positive returns in OTC stocks. It can contribute to incidents of fraud and manipulation by preventing retail investors from being able to counteract misinformation.”)

¹⁸ Id. at 6 (footnote omitted).

¹⁹ Release at 57 (footnotes omitted).

²⁰ Rule 15c2-11(f)(3)(i)(C), Release at 83-90. The SEC estimated that 69% of quoted securities that qualified for the piggyback exception had publicly available current disclosures. Release at 222 n.651.

²¹ Rule 15c2-11(f)(3)(i)(A). See Release at 107-109.

²² Rule 15c2-11(f)(3)(i)(A). Former Rule 15c2-11(f)(3)(ii) allowed piggybacking in an IDQS that did not specifically identify quotations that reflected unsolicited customer interest if the security was the subject of both bid and offer priced quotations with a specified frequency.

²³ Rule 15c2-11(f)(3)(i)(A). Former Rule 15c2-11(f)(3)(i) did not require priced quotations in an IDQS that specifically identified unsolicited customer interest.

²⁴ Rule 15c2-11(f)(3)(i)(B)(1).

- Piggybacking in the security of a shell company is limited to the 18-month period following the initial bid or offer priced quotation for the security in an IDQS.²⁵
- Broker-dealers may have a “grace period” to continue to piggyback after an issuer’s paragraph (b) information ceases to be current or publicly available within the prescribed time frames.²⁶

c. New exceptions: Rule 15c2-11(f)(5) and (6)

The SEC adopted novel exceptions from the information gathering and review requirements. The ADTV and asset test exception excludes the securities of issuers: that have reported worldwide average daily trading volume value of at least \$100,000 during the 60 calendar days before the publication of the quotation; and the issuer has at least \$50 million in total assets and \$10 million in shareholders’ equity as reflected in the issuer’s publicly available audited balance sheet issued within 6 months after the end of its most recent fiscal year.²⁷

The underwriter exception applies to a broker-dealer that was named as an underwriter in a registration statement for an offering for the security (other than a Form F-6) or an offering statement for a Regulation A offering. This exception applies only for the time frames specified in paragraphs (b)(1) and (2).²⁸

5. POSSIBLE EXEMPTIONS

Based on numerous comment letters that it received on the proposed amendments, the SEC expressly recognized that there are concerns about the loss of quoted markets for certain securities as a result of the implementation of the Rule, and stated that it would be open to considering requests for exemptions.²⁹ With particular focus on the loss of piggybacking, the SEC stated that the following factors would be relevant in considering an exemption request, depending upon the facts and circumstances:

- issuers and/or securities that are less susceptible to fraud or manipulation;
- securities that have an established prior history of regular quoting and trading activity;
- issuers that do not have an adverse regulatory history;
- issuers that have complied with any applicable state or local disclosure regulations that require that the issuer provide its financial information to its shareholders on a regular basis, such as annually;
- issuers that have complied with any tax obligations as of the most recent tax year;
- issuers that have recently made material disclosures as part of a reverse merger; and
- facts and circumstances that present other features that are consistent with the goals of the amended Rule of enhancing protections for investors, particularly retail investors.

Intriguingly, the SEC also said that it was open to the possibility of recognizing an “expert market” where the Rule would not apply. In such a market, quote distribution would be limited to “professional investors” and certain non-professional investors would only be allowed to liquidate holdings.³⁰ The SEC discussed some features of this market:³¹

²⁵ Rule 15c2-11(f)(3)(i)(B)(2). “Shell company” is defined in paragraph (e)(9) essentially as an issuer (other than a business combination related shell company or an asset-backed issuer) that has no or nominal operations and no or nominal assets or assets solely of cash and cash equivalents.

²⁶ See Rule 15c2-11(f)(3)(ii).

²⁷ Rule 15c2-11(f)(5). Approximately 8% of OTC quoted securities had ADTV value of more than \$100,000 in 2019. Release at 220. The SEC estimates that: approximately 180 (2%) of quoted OTC securities would be eligible for this exception; and, of the 3,489 securities that will lose piggybacking eligibility, 5 securities of issuers covered by paragraph (b)(1)-(4) would have satisfied the ADTV and assets tests. Release at 257-258 n.749.

²⁸ Rule 15c2-11(f)(6).

²⁹ See Release at 60-75.

³⁰ Release at 76.

³¹ Release at 77-78.

- It must not have the potential to develop into a parallel market for which quotations are accessible by retail investors and the general public; and
- It would be narrowly tailored to sophisticated investors, such as qualified institutional buyers, accredited investors, registered investment companies and investment advisers, banks, and broker-dealers.

The SEC recommended that requests for exemption be made expeditiously during the 9-month transition period.³²

6. SEC GUIDANCE³³

The former rule contained a Preliminary Note that referenced guidance that the SEC had issued in 1991 discussing procedures for gathering and reviewing required information and the requirement that a broker-dealer have a reasonable basis for believing that the information is accurate and obtained from reliable sources. In addition, the SEC had issued additional guidance in 1999 focussed on “red flags” that might be presented during the review of the information. The SEC removed the Preliminary Note and published guidance that updates and supersedes the earlier material. The new guidance applies to broker-dealers and QIDQs.

7. SOME OTHER ISSUES

It remains to be seen how many entities decide to become QIDQs or if FINRA decides to assume the roles that it is eligible to perform.³⁴

As noted in the Release, there are questions about the coordination of the Rule with FINRA Rule 6432.³⁵ That rule requires FINRA members to file Form 211 with FINRA at least 3 business days before publishing an OTC quotation, unless an exception is available. The role and obligations broker-dealers and QIDQs vis a vis FINRA’s requirements will need to be worked out.³⁶

The SEC “believes that the amendments should incentivize issuers to make their information current and publicly available to allow broker-dealers to continuously quote their securities.”³⁷ In other words, the prospective loss of an active market for their securities will motivate issuers to make or keep their information current and publicly available. The SEC has tools that it can use to further incentivize such issuers. For example, an issuer that becomes delinquent in filing its Exchange Act reports or a foreign issuer that fails to make its home country disclosure documents publicly available is failing in its statutory or regulatory obligations and depriving United States investors of the type of transparency that the SEC believes is essential to a vibrant OTC market. By rigorously enforcing compliance with an issuer’s obligations to make required filings and disclosures, the SEC could assist investors who are trying to determine the investment merits of an issuer’s securities, and broker-dealers and QIDQs that are trying to comply with the information gathering requirements or rely on the piggybacking exception so that they can provide a public market.³⁸

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³² Release at 176.

³³ Release at 161-175.

³⁴ See, e.g., Rule 15c2-11(a)(3), (d)(2), (f)(3)(ii), (f)(7).

³⁵ Release at 30.

³⁶ However, the SEC commented: “The amended Rule does not impose obligations with respect to FINRA Rule 6432 and does not require qualified IDQs, or broker-dealers relying on a qualified IDQs’s publicly available determination that an exception applies, to file Forms 211 with FINRA.” Release at 30.

³⁷ Release at 14 (footnote omitted).

³⁸ In this connection, see Murphy & McGonigle’s comment letter on the proposed amendments, <https://www.sec.gov/comments/s7-14-19/s71419-6526192-200403.pdf>.