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PENNY STOCKS

Regulatory Actions to Reduce Potential for Fraud and Abuse

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The Honorable Donald W. Riegle, Jr.
Chairman, Committee on Banking, Housing,
and Urban Affairs
United States Senate

The Honorable Christopher J. Dodd
Chairman, Subcommittee on Securities
Committee on Banking, Housing
and Urban Affairs
United States Senate

The Honorable John D. Dingell
Chairman, Committee on Energy and Commerce
House of Representatives

The Honorable Edward J. Markey
Chairman, Subcommittee on
Telecommunications and Finance
Committee on Energy and Commerce
House of Representatives

This report presents the results of our review of the National Association of Securities Dealers' efforts to reduce fraud and abuse in the penny stock market. Section 510 of the Penny Stock Reform Act of 1990 required us to study the Association's enforcement and oversight activities in the penny stock market.

This report discusses changes to the Association's oversight procedures for broker-dealers who conduct business in penny stocks. It recommends improvements in the Association's procedures for informing investors of broker-dealers' disciplinary and arbitration award history and for examining branch offices. It also discusses listing and delisting practices of the Association and stock exchanges.

We are providing copies of this report to interested Members of Congress, appropriate committees, the Securities and Exchange Commission, the National Association of Securities Dealers, other interested parties, and the public.

Major contributors to this report are listed in appendix VI. If you have any questions, please c
me at (202) 275-8678.

James L. Bothwell
Director, Financial Institutions
and Markets Issues

Executive Summary

Purpose

During the 1980s, unscrupulous broker-dealers used a variety of schemes to perpetrate widespread fraud and abuse by trading in low-priced securities known as penny stocks. Losses attributable to such fraud and manipulation in the sale of penny stocks may have cost investors as much as $2 billion annually. To address this problem, Congress enacted the Penny Stock Reform Act of 1990, which provided the Securities and Exchange Commission (SEC) with additional rulemaking authority and authority to sanction individuals involved in penny stock fraud and abuse. The act also required broker-dealers that sell penny stocks and companies that issue penny stocks to disclose information about the stock and the company before finalizing a penny stock sale.

The act did not provide additional authority to the self-regulatory organization—National Association of Securities Dealers (NASD)—that, under SEC's supervision, regulates broker-dealers, including those that trade in penny stocks. Instead, the act required GAO to obtain information on NASD's oversight of the penny stock market. GAO obtained available information on the overall status of penny stock activity and NASD's efforts to (1) increase its regulation of the market during recent years, (2) implement new information collection and dissemination systems, (3) coordinate enforcement with other federal and state authorities, and (4) examine penny stock broker-dealers' sales practices.

Background

Under Section 15A of the Securities Exchange Act of 1934, NASD was formed on July 20, 1939, as an association of broker-dealers for self-regulation of the over-the-counter securities market.

In the over-the-counter market, broker-dealers trade equity securities through a network of telephones and computers rather than on a centralized exchange floor. Penny stocks are traded primarily by telephone. NASD is responsible for monitoring its thousands of member broker-dealers' compliance with SEC and NASD rules governing the marketing and selling of securities to the public. NASD identifies violations of these rules by examining its members' financial operations and trading and sales practices. NASD also investigates specific allegations of prohibited activities, monitors trading, investigates customer complaints, and takes formal and informal enforcement actions against broker-dealers and their employees.

The segment of the over-the-counter market where penny stocks are traded has traditionally been prone to fraud and abuse. Largely because this market did not have a system to inform investors of the latest selling prices or volumes of stocks traded, investors had to rely on information provided by brokers. Likewise, because penny stock trades were not reported to them, regulators could not easily monitor trading activity. Th Penny Stock Reform Act required several changes to the market to ensu that investors would be better informed before completing any transacti in a penny stock and that trading in penny stocks could be adequately regulated. For example, the act requires broker-dealers, before completi any transaction in penny stocks, to disclose to investors the nature and levels of risks associated with the transaction and directs SEC to adopt rules requiring broker-dealers to disclose (1) the latest prices at which broker-dealers would buy or sell a penny stock, (2) the number of shares to which those prices apply, and (3) the amount of compensation that th broker-dealer would receive. The act also required development of a system for broker-dealers to report the prices and volumes of penny stoc trades.

GAO obtained information on the status of penny stock activity and NASD's efforts to regulate the penny stock market by (1) reviewing documents a data provided by SEC and NASD and (2) interviewing officials from SEC, NA law enforcement agencies, and market participants. GAO obtained information on NASD's application of its examination procedures by reviewing files of examinations completed during 1988 through 1990 of penny stock broker-dealers in the Atlanta, Denver, and New York district

Results in Brief

SEC statistics show that the number of broker-dealers trading penny stoc and complaints involving penny stocks have decreased in recent years. However, continued complaints by investors and findings of ongoing investigations about new tactics that people are using to avoid detection penny stock fraud and abuse indicate that the problem of penny stock fraud is still a significant threat to investors. Consequently, GAO believes that the potential for fraud and abuse remains high.

NASD's efforts to improve its regulation of the penny stock market include increased staffing and programs designed to detect, investigate, and prosecute penny stock fraud and abuse. It has also cooperated in penny stock investigations and task forces with SEC, state regulators, and federa and local law enforcement agencies. These efforts have resulted in both informal corrective actions and formal actions such as expulsions, fines, and suspensions of penny stock broker-dealers and their employees.

Several federal and state officials told us that well-informed public investors are the best weapon against penny stock fraud and abuse. NASD plans to implement a new information system in 1993 to provide immediate information on each penny stock transaction. NASD expects this system to provide investors with better information on which to make penny stock buy and sell decisions and enhance NASD's ability to detect manipulative and abusive trading practices by broker-dealers. NASD also now operates a toll-free service that provides investors with information on broker-dealers' disciplinary histories. However, this service does not provide information on arbitration awards against the broker-dealers. Arbitration information may be important to investors when they are deciding whether to enter a business relationship with a broker-dealer.

One of NASD's primary methods for identifying penny stock abuse is to examine broker-dealers' sales practices. GAO found that NASD generally adhered to its examination schedule for the main offices of these broker-dealers. However, NASD policy allows each district to determine the number of branch offices examined each year and the frequency of branch office examinations. GAO found that the Atlanta district examined many branch offices of penny stock broker-dealers during 1988 through 1990. However, NASD's Denver district did not complete any examinations of penny stock broker-dealers' branch offices and the New York district completed only one branch office examination. NASD prefers to cover branch operations by reviewing records at the main offices. With periodic on-site visits to the branch offices of penny stock broker-dealers in all NASD districts, NASD could (1) better detect sales practice violations, (2) determine whether the branches have conducted business independent of the main office, and (3) determine whether branch employees are properly registered with NASD and supervised by the broker-dealer.

GAO's Analysis

Principal Findings

Status of Penny Stock Activity

SEC data showed that between 1988 and mid-1992, the number of broker-dealers dealing in penny stocks decreased by 49 percent, from 324 to 165, and quarterly trading gains and commissions of penny stock broker-dealers on transactions in over-the-counter securities decreased by

37 percent, from $258 million to $162 million. The data also showed that complaints received by SEC between 1989 and 1991 about penny stock broker-dealers decreased by 78 percent, from 3,863 to 822. SEC and other regulators attributed the decline in penny stock activity to new regulations, stepped up enforcement efforts, publicity about penny stock fraud, and a general decline in stock market activity during 1989 and 199 (See pp. 20-21.)

SEC data also indicated that problems with penny stocks, although diminished, still exist. For the first 4 months of fiscal year 1992, SEC received 269 investor complaints concerning penny stocks.

Further, at a February 1992 meeting on penny stock abuses, officials of regulatory and law enforcement agencies said that investigations have continued to uncover several ongoing penny stock fraudulent schemes a that new tactics were being used to avoid detection. (See p. 21.)

NASD's Efforts to Better Inform Investors About Penny Stocks

NASD officials said they plan to implement an automated reporting systen in 1993 that will provide investors with information on the prices and volumes of penny stocks immediately after a trade takes place rather tha the current end-of-day reporting to NASD. This information should help investors to better determine the reasonableness of the prices quoted by their brokers. The information should also help provide market surveillance analysts at NASD and SEC with data they need to reconstruct market activity and review for possible abusive and manipulative practices. (See pp. 29-31.)

NASD's 800-number service, begun on October 1, 1991, is intended to be a convenient way to inform investors about their brokers' past disciplinary records and certain criminal convictions, if any, so the investors can consider that information in deciding whether to purchase an investment Although a history of arbitration awards against a broker-dealer or one o its employees could be important information to an investor when deciding whether to enter a business arrangement with that broker, NASD practice is not to provide this information through the toll-free service. Ir GAO's opinion, this practice diminishes the service's usefulness and convenience and may mislead the investors.

Because the toll-free operators do not have arbitration information befor them when they respond to phone inquiries, investors could interpret the absence of the information to mean that no arbitration awards have been made against a broker even though this might not be true. Under current policies and procedures, for investors to obtain information on arbitration awards from NASD, they must (1) somehow learn that an arbitration award has been made against a broker-dealer, (2) request the results of the award from NASD, and (3) pay a $5 fee. Having the operators inform the callers that they do not have arbitration information and provide the callers with information on the procedures for obtaining this information would still leave the caller with a burdensome and more costly process than the toll-free service. (See pp. 31-33.)

On January 19, 1993, NASD announced that the NASD Board of Governors had acted to make disciplinary and arbitration award information available over the same toll-free number. The board approved a proposal to expand the information available through the toll-free number to include civil judgments involving securities matters; pending formal disciplinary proceedings initiated by SEC, NASD, other self-regulatory organizations, and the states; criminal indictments and related information; and arbitration decisions. NASD said that it will submit the proposal to SEC for approval and expects to have the expanded information available by mid-1993.

NASD Efforts to Oversee Penny Stock Trading

NASD has made several operational changes in recent years to combat penny stock fraud and abuse. These changes include increasing anti-fraud investigation staff years from 17.5 to 36 and surveillance staff from 1 to 10 persons between 1988 and 1991; requiring broker-dealers to report end-of-day surveillance information on the price and volume of penny stocks traded in the over-the-counter stock market; revising examination procedures to focus on potentially serious sales practice violations that are commonly associated with fraudulent and abusive penny stock trading; and monitoring trading in new issues of penny stocks to detect instances of possible fraud and manipulation. (See app. III.)

GAO's analysis of NASD data showed that many enforcement actions were taken against penny stock rule violators. From 1988 through 1991, NASD's disciplinary committees censured 216 penny stock broker-dealers and associated persons, fined penny stock broker-dealers and associated persons $18.4 million, expelled 29 penny stock broker-dealers from membership, barred 74 penny stock broker-dealers and associated persons from practice in the securities industry, and temporarily suspended 98 persons from practice for violations involving penny stocks. (See pp. 46-47.) Also, GAO found that most rule violations identified by NASD's Atlanta, Denver, and New York districts during 1988 through 1990 examinations of penny stock broker-dealers resulted in informal corrective actions. For example, informal actions were recommended 16 times, while formal actions were recommended 30 times. (See pp. 37-38.)

In addition to its own surveillance, examination, and investigation activities, NASD also cooperates with other regulatory and law enforceme authorities by participating in established task forces, providing staff assistance, and sharing information. NASD has worked with SEC's national Penny Stock Task Force by sharing its expertise with the regulatory bodies involved. In 1988, SEC's Miami branch office, the Florida Securitie: Division, and NASD established the Florida Penny Stock Task Force to address common penny stock regulatory problems. Staff from NASD's headquarters office and the Atlanta, Denver, and New York districts participate in the task force, which includes national and international securities regulators and law enforcement agencies. It meets quarterly to discuss new programs and developments, examination and enforcement activities, and specific areas of concern regarding the activities of penny stock broker-dealers and the companies that issue penny stock. The task force, which now calls itself The Florida Conference, recently broadenec its scope to consider matters involving other securities. (See pp. 43-44.)

NASD staff from the three districts and headquarters share information an expertise with other state and federal authorities. For example, staff fror the New York district were detailed to the Manhattan District Attorney, t U.S. Attorneys for the Southern and Eastern districts of New York, and tl U.S. Attorney for New Jersey. The NASD staff generally provided advice o securities laws and helped develop evidence. Officials of the law enforcement agencies with whom GAO spoke said that the NASD staff wer instrumental in developing several successful cases. (See pp. 44-45 and app. II.)

NASD Policy Does Not Require Periodic Branch Office Examinations

Regulators and law enforcement officials told us that, when penny stock fraud has been found, it has often involved branch offices of broker-dealers. Some of the branch office examinations that have been done have detected cases of fraud and abuse. For example, branch office examinations by NASD's Atlanta district found several cases of serious markup violations. Further, during a special examination sweep of franchises—broker-dealers that use the overall company name but opera independently from the main offices and are treated as branch offices by NASD—SEC and NASD examiners found cases of fraudulent misrepresentation, misuse of customer funds, unauthorized trades, excessive markups, and failure to supervise employees. The examiners also found a statutorily disqualified person functioning as a broker without being registered and found other unregistered broker-dealers. (See pp. 38-39.)

GAO's review of records of closed 1988 through 1990 examinations by three NASD districts showed that the Atlanta district examined nine branch offices of penny stock broker-dealers while the Denver and New York districts did not examine any such branches in their districts. After it reviewed a draft of this report, NASD provided GAO with 26 additional Atlanta district branch office examinations of penny stock broker-dealers that were closed after our review but for which fieldwork had been completed during 1988 through 1990. NASD also provided GAO with one New York district examination of a penny stock broker-dealer branch office. Even with those additional examinations, neither the Denver district nor the New York district covered many of the branch offices in their districts. From NASD data, GAO identified 199 branch offices of penny stock broker-dealers of which 66 were in NASD's Atlanta district, 80 in the Denver district, and 53 in the New York district. (See p. 38.)

Although NASD's examination guidance established in February 1989 placed greater emphasis on special sales practice branch office examinations, NASD officials told GAO that NASD does not routinely visit branch offices because it reviews records of branch office transactions during the main office examination. They said that this procedure is sufficient because the branches' transactions are finalized by the main offices and records are kept at the main offices. However, SEC and NASD officials said that, with on-site examinations of the branches, NASD could better detect sales practice violations and check to see whether (1) branch office employees are properly registered, (2) employees are properly supervised, and (3) the branch is conducting business independent of the main office. (See pp. 38 and 39.)

Because of the potential for fraudulent practices that branches present, GAO believes it is important that a sufficient number of branches be visited in all of NASD's districts where penny stock broker-dealers have branch offices to identify and deter abusive practices that cannot be identified at the main offices. Currently, NASD does not have standards or a plan for determining the frequency of branch office visits needed to deter abusive and fraudulent practices. To develop such a plan, NASD would have to conduct a detailed analysis to determine how many and how often branches should be examined, including a sampling plan that targets high-risk branches, and the number of employees that would be requirec to examine branches. (See p. 39.)

Recommendations

GAO recommends that the Chairman, SEC, require NASD to

- provide public investors who request information via NASD's toll-free phc service with information on final arbitration awards; and
- develop a plan for examining the branch offices of penny stock broker-dealers in all NASD districts that includes a sampling plan to ident high-risk branches, establishes the frequency of examinations, and determines the number of employees that would be required to examine branches. (See p. 48.)

Agency Comments

GAO obtained written comments on a draft of this report from SEC and NA The written comments are shown in appendixes IV and V.

SEC supported both of GAO's recommendations and suggested technical changes that were made where appropriate.

NASD said that GAO's report presented a fair and accurate assessment of NASD's regulatory and enforcement initiatives in the penny stock market. As noted above, NASD has positively responded to GAO's recommendation to expand information available on the toll-free number. It also emphasized that while it has no specific cycle established to examine branch offices, each NASD district is to annually establish a program of special branch office sales practice examinations.

GAO continues to believe that NASD's policy allowing the districts to determine the extent to which branch offices will be examined has resulted in inconsistent examination coverage of branch offices of penny stock broker-dealers. Such inconsistent coverage provides the opportuni for unscrupulous broker-dealers, who use fraudulent and abusive practices in dealing with the public, to go unchecked.

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Appendixes

Tables

Abbreviations

Amex	American Stock Exchange
BSE	Boston Stock Exchange
FBI	Federal Bureau of Investigation
NASD	National Association of Securities Dealers
NASDAQ	National Association of Securities Dealers Automated Quotation
NMS	National Market System
NYSE	New York Stock Exchange
Phlx	Philadelphia Stock Exchange
PSE	Pacific Stock Exchange
SEC	Securities and Exchange Commission

Introduction

The Penny Stock Reform Act of 1990 was enacted on October 15, 1990, with the intention of curbing pervasive fraud and manipulation in the penny stock market. The act provides the Securities and Exchange Commission (SEC) with additional authority and establishes a system for more comprehensive disclosure of information about securities designat as penny stocks that broker-dealers recommend to their customers as investments and the market in which these securities trade. The act also instructs us to review the enforcement and oversight activities of the self-regulatory organizations that oversee their members' activities in the penny stock market. The National Association of Securities Dealers (NASI is the self-regulatory organization responsible for regulation of the segment of the over-the-counter stock market[1] where penny stocks are traded.

NASD's Regulation of the Penny Stock Market

NASD was formed on July 20, 1939, as a nonprofit association of broker-dealers[2] who participate in the over-the-counter securities market NASD's legal authority is derived from Section 15A of the Securities Exchange Act of 1934. Section 15A, known as the Maloney Act amendments, became law on June 25, 1938. The amendments provided fc the establishment of NASD to supervise the over-the-counter securities market. The amendments also required that NASD be registered with SEC and that SEC prescribe rules governing NASD as necessary or appropriate i the public interest or for the protection of investors. NASD's rules were to be designed to prevent fraudulent and manipulative practices and to promote just and equitable principles of trade. NASD's revenues are obtained primarily from assessments on members and various user fees.

Section 15A charged NASD with responsibility to enforce members' compliance with federal securities laws and regulations and to take disciplinary action against members and associated persons.[3] NASD fulfills this responsibility through its rulemaking and oversight functions. Each c NASD's 11 districts has a committee, made up of locally elected

[1]The over-the-counter market is the market in which broker-dealers trade securities through a netwo of telephones and computers rather than on a centralized exchange floor. In the segment of the over-the-counter market where penny stocks are traded, the trades are executed by broker-dealers communicating with each other by telephone. See NASD's comments in appendix V for detailed information on the different segments of the over-the-counter stock market.

[2]A broker-dealer both acts as an agent for buyers and sellers of securities (broker) and trades in securities for its own account (dealer).

[3]An associated person is any person—partner, officer, director, salesperson, trader, manager, or employee—engaged in investment banking or securities business who is directly or indirectly controlling or controlled by an NASD member.

broker-dealers from the district, that functions as an agent of NASD's Board of Governors in executing NASD policy. When these district committees function in a disciplinary capacity, they become district business conduct committees, which act as independent fact finders in disciplinary matters. The committees are responsible for reviewing examination reports, reviewing staff investigations of NASD members, administering disciplinary proceedings, and imposing sanctions for violations of federal and state laws, Municipal Securities Rulemaking Board rules,[4] and NASD's rules of fair practice.

At the national level, NASD has a Market Surveillance Committee that administers disciplinary proceedings that result from investigations by the Market Surveillance and Anti-Fraud departments and hears serious district office cases of market-related violations, such as manipulation or insider trading. NASD also has a National Business Conduct Committee that reviews all decisions rendered by, and hears appeals of decisions by, the district business conduct committees and the Market Surveillance Committee to ensure that decisions are consistent with established NASD policy.

In addition to regulation of the broker-dealers who trade in the over-the-counter market, NASD operates the National Association of Securities Dealers Automated Quotation (NASDAQ) system and National Market System (NMS). NASDAQ is a nationwide electronic system that collects bid (prices at which subscribers are willing to buy stock) and ask (prices at which subscribers are willing to sell stock) price quotations and disseminates the data to subscribers and information vendors worldwide. NMS provides a variety of services, including systems for the automatic execution of buy and sell orders and reports on the price and volume of the last sale for each listed stock. To list stock on these systems, companies must meet specified criteria for number of shareholders, assets, and trading activity. NMS criteria are higher than NASDAQ's and are similar to the listing requirements of the American Stock Exchange (Amex).

[4]This is a board of industry and public representatives designed to create rules and regulations for municipal bond trading.

Penny Stocks Have Been Used to Defraud Investors but Also Include Legitimate Offerings of Small Companies

The term "penny stock"[5] is used to describe highly speculative, low-price securities traded in the over-the-counter market. Although traditionally priced at less than $1, penny stocks can sell at prices that range from a fraction of a cent to $5 per share. While penny stocks have frequently be used to defraud investors, penny stocks may also include bona fide offerings of smaller companies. Penny stocks have been used to finance small, innovative companies that have developed into successful corporations.

Generally, penny stocks are issued by smaller companies that do not hav the assets, earnings, and trading activity to meet the NASDAQ listing requirements.[6] Before 1990, penny stock prices were quoted only in print media such as the National Quotation Bureau-published "pink sheets." Tl pink sheets, which are published for each trading day, provide bid and as prices for thousands of stocks that are not printed in newspaper over-the-counter listings. However, the pink sheets are not widely disseminated and are subscribed to primarily by broker-dealers. In 1990, NASD began operating its automated Over-the-Counter Bulletin Board to capture and display quotation information from NASD members that function as market makers[7] for penny stocks and other over-the-counter securities that are not listed on NASDAQ. Only NASD members can subscrib to the Bulletin Board service. As of June 1992, about 4,100 stocks were listed on the Bulletin Board, which has no listing and maintenance requirements for stock issuers other than that stocks not be listed on NASDAQ or an exchange. However, SEC Rule 15c2-11 and Schedule H of NASD's by-laws, which are described by NASD in appendix V, require that issuers must generate and broker-dealers that act as market makers mus review and maintain financial and other information on stocks and the issuers. According to NASD officials, NASD's Anti-Fraud Department also analyzes this information to identify and require correction of deficiencie

[5]As defined by the Securities Exchange Act of 1934 and applicable regulations, a penny stock is an equity security that is issued by a company with net tangible assets of less than $5 million if in continuous operation for less than 3 years, or less than $2 million if in continuous operation for at le 3 years, or average revenue of at least $6 million for the last 3 years. A security is not a penny stock i is (1) subject to last sale reports that are disseminated to the general public, (2) listed and traded on registered stock exchange or authorized for quotation on NASDAQ, or (3) issued by a registered investment company. SEC rules currently interpret penny stocks as having an offer price of less thar $5.

[6]NASD competes with the other exchanges in an effort to get issuers to list on NASDAQ and NMS. NASDAQ has been viewed as the start-up exchange for smaller companies that cannot meet the New York Stock Exchange (NYSE) or Amex listing requirements. According to NASD, many companies meet the financial requirements for listing on NYSE and Amex but choose NASDAQ for competitive reasons.

[7]A market maker is a broker-dealer that holds itself out in the over-the-counter market as being willi to buy and sell a security for its own account on a regular or continuous basis.

How Penny Stock Fraud Has Been Committed

Penny stock fraud and abuse may involve broker-dealers selling stock of nonexistent or worthless companies using high-pressure sales techniques, price manipulation,[8] and excessive markups.[9] A penny stock scam could involve the use of one or any combination of these techniques. For example, a typical penny stock scam might rely on stock of a preexisting "shell company" that actually has minimal assets, no revenues or employees, and does not produce a product. Stock in such a company does not have to be registered with SEC if the company was incorporated before the Securities Act of 1933.

In our example, the initial public offering of a penny stock would be sold to people involved in the scam known as "nominee accounts" who then would sell the stock to a broker-dealer that would also be part of the scam, acting as a market maker for the stock. To provide the semblance of a viable market, the market maker would resell the stocks to other involved accounts, such as relatives or friends, at predetermined higher prices. To make the stock appear to be a winner, the promoters might claim to have discovered a medical breakthrough or highly innovative products. With the support of such claims, the market maker would solicit investors to purchase the stock, often using high-pressure, boiler-room sales tactics[10] with assurances of financial gain. To ensure a profit for the market maker, the stock would be sold at prices well in excess of the price the market maker paid for it or bought well below the price at which the market maker would be willing to purchase it. The stock would be sold and resold among investors at inflated prices and then, at a predetermined price, the market maker would refuse to accept sell orders, thus leaving the final investors holding worthless stock.

[8]Price manipulation involves transactions that either cause a rise or decline in the price of a security or create actual or apparent active trading in its market so as to induce the purchase or sale of the security by others.

[9]When a broker-dealer engages in a principal transaction with a customer, it charges the customer a markup or a markdown. A markup is the difference between the prevailing market price for a security and the price the customer actually pays the broker-dealer. A markdown is the difference between the prevailing market price for a security and the price the customer receives for selling the security to the broker-dealer. In April 1992, NASD issued Notice to Members 92-16, which provides guidance on markups and markdowns. Recent NASD disciplinary actions regarding markups and markdowns are noted in appendix V.

[10]In a boiler-room operation, the penny stock broker uses a bank of telephones operated by high-pressure salespersons who push stocks to uninformed investors. The salespersons make outrageous claims, such as that the stock will soon double in price, and demand an on-the-spot buy decision.

History of Penny Stocks

Past studies trace the history of penny stocks back to speculation surrounding the Colorado gold mining boom of the 1880s. The issuance and trading of penny stocks were also prevalent during the 1950s when th U.S. Atomic Energy Commission announced that it was seeking to purchase all available quantities of uranium. Thousands of investors lost millions of dollars in worthless, low-priced uranium stocks sold in coffee shops in Salt Lake City, Utah. Until about 1983, the market for penny stocks was concentrated mostly in the Denver, Salt Lake City, and Spokane regions.

Until recent years, the penny stock market was focused on "hot issues"—initial public offerings of small new companies with professed bright and profitable futures in energy and mining or high-tech and health-related breakthroughs. Because of the cyclical and unpredictable nature of these "hot issues," there was little opportunity for broker-dealer to develop a large enough investor base for a nationwide penny stock market. However, during the mid-1980s, penny stock brokers intensified their efforts to trade not just in the new "hot issues" but in the secondary market where stocks are traded after their initial offering and where access to a large investor base was possible. The brokers were aided by the widespread availability of computers and telefax machines, inexpensive long-distance access through toll-free phone numbers, and th ability to buy telephone lists of potential investors. With these innovation penny stock scam artists began operating nationally, even globally.

The scope of the penny stock problem thus became widespread. In September 1989, the North American Securities Administrators Association estimated that $2 billion of investors' funds were lost to penn stock fraud and abuse annually. An association survey showed that penny stock complaints were reported in 49 of 50 states during 1988. Also, according to SEC, about 20 percent of SEC's penny stock investigations now involve foreign countries.

Available data showed that the number of participants and the earnings from trading in penny stocks have diminished recently. Between the end of the third quarter of 1988 and the end of the second quarter of 1992, SEC data showed that the number of broker-dealers trading in penny stocks decreased by 49 percent, from 324 to 165; the total capital of penny stock broker-dealers decreased by 59 percent, from $583 million to $240 million and quarterly trading gains and commissions of penny stock broker-dealers on transactions in over-the-counter securities decreased b 37 percent, from $258 million to $162 million. SEC data also showed a decline in the number of complaints received by SEC about penny stock broker-dealers from a high of 3,863 in 1989 to 822 in 1991. Although the number of SEC enforcement actions has increased from 43 in fiscal year 1988 to 116 in fiscal year 1991, this increase could reflect actions resulting from investigative efforts on complaints received in earlier years. According to SEC and other regulatory officials, the overall decline in penny stock activity is a combined result of new regulations, stepped-up enforcement efforts, publicity about penny stock fraud, and a general decline in stock market activity during 1989 and 1990. NASD said that the reduction in the number of penny stock broker-dealers strongly supports a conclusion that ongoing regulatory enforcement efforts continue to have a significant effect in curtailing penny stock abuses.

The decline in penny stock activity does not mean that the penny stock fraud and abuse problems have been resolved or are no longer a matter of regulatory concern. During the first 4 months of fiscal year 1992, SEC received 269 customer complaints against penny stock broker-dealers and, as of June 1992, SEC had identified 165 active penny stock broker-dealers.[11] Further, at a February 1992 meeting, officials of regulatory and law enforcement agencies from several U.S. and Canadian locations said that penny stock promoters and dealers are now using new tactics to avoid detection of fraud and abuses. Law enforcement officials also told us of how penny stock issuers are trying to avoid the new penny stock rules by using phony financial information to price stocks just above $5, so that the stocks no longer meet the penny stock definition. NASD said that there are cases under review that involve securities priced above $5 and that it closely monitors the securities sold by penny stock broker-dealers to detect any change in product mix and pursues any questionable activity.

New Law and SEC Rules Expand Penny Stock Regulation

To curtail fraud and abuse in the penny stock market, the Penny Stock Reform Act of 1990 provides for expanded regulation of the penny stock market. The reform act gives SEC authority to impose sanctions for rule violations by any person participating in a penny stock offering, including any person acting as a promoter, consultant, or agent or any other person who engages in activities with a broker-dealer or stock issuer.[12] The act and regulations issued thereunder require that broker-dealers, before

[11]NASD officials said that SEC's count overstates the number of penny stock broker-dealers because SEC includes clearing agents and wholesale dealers who normally do not do business with retail customers. According to SEC, it counts these firms because they can potentially play a role in any scheme to manipulate the market for low-priced securities.

[12]An issuer is a legal entity that has power to issue and distribute securities, such as corporations, municipalities, governments, or investment trusts.

completing any transaction in penny stocks, disclose to customers (1) the nature and levels of risks associated with the transaction, (2) bid and ask prices, (3) the number of shares to which those prices are applicable, and (4) the amount of compensation that the broker-dealer would receive fro such a transaction. Broker-dealers also must provide the customer with monthly account statements. The act further requires the development of an automated price quotation system for penny stocks and requires NASD to establish a toll-free 800 number to receive inquiries regarding disciplinary actions involving its broker-dealer members and associated persons. In addition, the act directs SEC to develop special rules for blank check offerings.[13]

In April 1992, SEC adopted rules to implement the act's various provisions. The SEC rules require broker-dealers to provide investors with disclosure statements on the risks of investing in penny stocks and with current bid and ask prices, broker-dealer and associated person compensation, and monthly account statements. SEC also adopted a rule requiring that the proceeds of blank check offerings be held in an escrow or trust account until the issuer of the offering discloses in a prospectus the intended acquisition of a business or assets. At that time, investors have the opportunity to recoup their funds. Most of the disclosure rules became effective on January 1, 1993. The blank check offering rule went into effec on April 28, 1992.

Before the Penny Stock Reform Act, SEC adopted Rule 15c2-6, referred to as "the cold call rule," which became effective in January 1990 and which imposes sales practice and suitability requirements on broker-dealers wh recommend purchases of low-priced, over-the-counter securities that are not listed on NASDAQ to persons who are not established customers. The rule was designed to discourage fraudulent sales tactics used by broker-dealers engaged in boiler-room operations. Cold calls are telephon calls made to persons whose names are drawn from a telephone directory or membership list, many of whom have little investment experience. The boiler-room salespersons are trained in high-pressure and false or misleading sales tactics designed to elicit a buy decision during the call. T stop fraudulent solicitation of investors in penny stocks, the cold call rule requires a broker-dealer to obtain sufficient information about a new customer to determine whether high-risk penny stocks would be a suitabl investment for the customer. The broker-dealer then must provide the customer with a written statement of this suitability determination and

[13]A blank check offering is an offering of a security in which the issuer discloses no specific business plan or purpose.

obtain a signed copy from the customer. The broker-dealer also must obtain a written agreement from the customer setting forth the identity and quantity of penny stocks to be purchased.

The requirements of the cold call rule are intended to help investors protect themselves from fraudulent sales practices and to reinforce broker-dealers' suitability obligations. To satisfy these obligations, broker-dealers are supposed to ensure that customers have the expertise and financial means to assume investment risks. SEC considered the extra protection provided by the rule essential because of a general lack of public information about the companies that issue penny stocks and the stocks' trading volume and prices. NASD's comments, in appendix V, provide information on its role in enforcement of Rule 15c2-6. Selected SEC and NASD rules applicable to penny stocks are listed in appendix I.

Objectives, Scope, and Methodology

As the Penny Stock Reform Act of 1990 requires, our objectives were to obtain and report information on NASD's oversight of the penny stock market. That information included the employees that NASD devotes to penny stock regulation; rules, procedures, and techniques used by NASD in penny stock regulation, including cooperative enforcement efforts with federal and state authorities. We are also required to report on stock exchange and NASDAQ listing and maintenance requirements and procedures that help ensure that only qualified stocks are listed on the exchanges or NASDAQ.

To provide information on the number of employees NASD devotes to penny stock regulation, NASD surveyed its component organizations and estimated the number of employees devoted to penny stock regulation. For NASD functions for which all or most employees are normally devoted to penny stock work, such as its Anti-Fraud Department and the group in the Market Surveillance Department that monitors trading in over-the-counter securities that are not listed on NASDAQ, actual staffing data were provided.

To identify and understand NASD's regulatory rules, procedures, and techniques, including cooperative enforcement efforts with federal and state authorities, we (1) reviewed various documents on the operations of the penny stock market and NASD's regulatory function and (2) interviewed the following: officials of NASD and SEC; U.S. Attorneys for Utah, New Jersey, the Southern District of Florida, and the Southern District of New York; FBI officials in Washington, D.C., Miami, Denver, Salt Lake City, and

Newark; state regulators in California, Colorado, Florida, New Jersey, New York, and Utah; the Manhattan District Attorney; the U.S. Department of Justice's Securities and Commodities Fraud Working Group; and market participants. We visited NASD's Washington, D.C. headquarters and its Atlanta, Denver, and New York districts. We selected these three NASD districts because in NASD's percentages of penny stock broker-dealers located in the districts they all were among the highest, and they all had histories of problems with penny stocks.

To assess how NASD used its regulatory procedures and techniques for the over-the-counter stock market, we compared NASD's stated policies to actual procedures and techniques in NASD's Atlanta, Denver, and New York districts during 1988 through 1990. From NASD's database of examinations, we identified the universe of 234 routine and sales practice examinations of penny stock broker-dealers in the 3 districts. All 234 examinations were closed[14] between January 1, 1988, and December 31, 1990. Of these 234 examinations, we reviewed 204; the other 30 examinations were not available because the examination files were no longer located in the district offices, or the examination decisions were being appealed and were thus no longer "closed."

From NASD's database, we also identified customer complaint examinations that were closed between January 1, 1988, and December 31, 1990. We reviewed all 63 customer complaint cases closed by the Atlanta district, all 97 complaint cases closed by the Denver district, and a representative sample of 80 out of 263 customer complaint cases closed by the New York district. In addition, for the 3 districts, we reviewed all 22 termination for cause examinations and 49 district office investigations of alleged violations.[15] We also reviewed 53 Anti-Fraud Department investigations that involved penny stocks that NASD completed between 1988 and May 1991.[16] We identified the examinations of penny stock broker-dealers by comparing NASD's database of examinations to a NASD list of broker-dealers that NASD and SEC identified as doing business primarily in penny stocks as of January 1991.

[14]An examination is "closed" after the examination report is reviewed by the responsible NASD district committee and a final action is taken, whether it be to impose a remedial sanction, file a formal complaint against the broker-dealer, or file the examination without any further action.

[15]We did not review one New York district office investigation because the investigation file was not available in the district at the time of our audit work.

[16]After the completion of our audit work, NASD identified another four Anti-Fraud Department investigations that involved penny stocks that we did not review or include in the results shown in this report.

We selected the 1988 through 1990 period for NASD examinations because of NASD's 3-year file retention policy and because 1990 was the last full calendar year before our review started. NASD began using revised examination procedures in July 1990, but both the earlier and the new procedures covered broker-dealers' financial condition and sales practices, which are key areas of concern for penny stock fraud and abuse. We also documented the examination results but did not judge the adequacy of any disciplinary actions resulting from the examinations.

To identify any known weaknesses in NASD's examination program, we reviewed SEC inspection reports of NASD's operations completed between September 1989 and February 1991. SEC periodically inspects NASD's regulatory operations, including NASD's district offices. The SEC inspections identify deficiencies in the districts' examinations and other district operations.

To obtain additional views on NASD's regulation of the penny stock market, we spoke with officials of the National Consumers League, Consumer Federation of America, Association of Publicly Traded Companies, Securities Traders Association, and representatives of 11 broker-dealers located in NASD's Denver and New York districts. Broker-dealers that we contacted in South Florida declined to speak to us because they said that they no longer had business in penny stocks.

To determine whether exchange listing and maintenance requirements were being followed, we reviewed the listing procedures, listing application files, and delisting actions of the American Stock Exchange (Amex), the Boston Stock Exchange (BSE), NASDAQ and NASD's National Market System (NMS), the New York Stock Exchange (NYSE), the Philadelphia Stock Exchange (Phlx), and the Pacific Stock Exchange (PSE).[17] The number of listings and delistings reviewed are shown in table 1.1.

[17]Although we contacted the Cincinnati and Midwest Stock Exchanges and obtained information on their listing procedures, we did not include them in our review because they each had only a few exclusive stock listings during the period of our review.

Table 1.1: Number of Exchange Listings and Delistings Reviewed

Exchange	Number of listings	Number reviewed	Number of delistings	Num revie
Amex	167	167	212	
BSE	60	60	43	
NASDAQ	410	150[a]	695	
NMS	165	75[a]	273	
NYSE	340	100[a]	210	
Phlx	11	11	16	
PSE	17	17	25	

[a]Random sample reviewed.

Source: GAO analysis of exchange records.

Our review focused on the stock markets' listings and delistings for the period after SEC's February 1989 announcement of the proposed cold cal rule. The review period for NYSE, Amex, and the regional stock exchanges was from February 1989 through August 1991. The review period for NMS and NASDAQ was from February 1989 through the end of 1990. We selecte this period for the NASD-operated markets because it ended at the same time as our review period for other NASD operations. In reviewing the listings and delistings, we did not attempt to make a preliminary distinction as to whether a stock met the criteria of a penny stock.

This portion of our review stemmed from concerns that unethical penny stock issuers could avoid the cold call rule and other penny stock regulations by listing on regional exchanges or NASDAQ.[18] To address this concern, we determined whether the listings adhered to the exchanges' requirements under the postulate that, when requirements were not beir adhered to, the potential for erosion of the requirements existed and it would be possible for an unethical penny stock issuer to list on the exchanges. By doing so, the issuer could avoid regulation as a penny sto because exchange-listed and NASDAQ-listed stocks, at the time, were exempt from penny stock rules.

[18]The definition of penny stock was changed with the April 1992 adoption of SEC regulations to implement the provisions of the Penny Stock Reform Act. Under the new definition, being listed on regional exchange is no longer sufficient justification for exclusion from regulation as a penny stocl Among other requirements, stocks listed on regional exchanges must be both listed and traded on tl exchange or must meet NYSE or Amex listing requirements before being excluded from regulation a penny stocks. Stocks listed on NYSE, Amex, NMS, and NASDAQ for which current information on t prices and volumes of transactions is reported and publicly disseminated on a continuing basis are excluded from regulation as penny stocks.

All of the random samples were selected to provide estimates at a 95-percent level of confidence with a sampling error of plus or minus 5 percent.

We did our audit work in accordance with generally accepted government auditing standards between February 1991 and May 1992. We obtained comments on a draft of this report from NASD and SEC and discussed applicable parts of the report with officials of the stock exchanges mentioned in the report.

NASD's Resources, Procedures, and Techniques for Regulation of the Penny Stock Market

As part of its oversight of the over-the-counter stock market, NASD uses various methods and techniques in its regulation of penny stock trading and broker-dealers. These methods include monitoring trading and sales practices, disseminating information to public investors, establishing rul examining member broker-dealers, investigating fraud and manipulation, and taking part in cooperative enforcement efforts. NASD now operates a toll-free service that provides investors with information on broker-dealers' and their employees' disciplinary histories. Although this service currently does not provide useful information on arbitration awards against the broker-dealers, NASD has acted to add this informatior to the service. We found that NASD has generally adhered to its examination schedule and procedures for routine and special examinations[1] of the main offices of penny stock broker-dealers. Howeve NASD's policy allows its districts to decide on the frequency of branch office examinations. While the Atlanta district examined many branch offices of penny stock broker-dealers between 1988 and 1990, the Denver district did not provide us with examination files for any branch office examinations, and the New York district completed only one branch offic examination. Without branch office examinations, NASD may miss sales practice abuses committed at branch offices and cannot determine whether the branches conducted business that was not reported to the main offices or whether the branches fully complied with rules governing (1) registration of employees with NASD and (2) supervision of employees

NASD Resources Devoted to Penny Stock Regulation

The Penny Stock Reform Act requires that we report on the amount of resources that NASD devotes to penny stock regulation. We were unable t directly obtain information on NASD expenses and employees devoted to penny stock regulation because NASD's work involving the broker-dealers that sell penny stocks is, in most instances, not segregated from its regulatory work on all of its member broker-dealers. However, NASD agreed to survey its component organizations to obtain estimates of the amount of expenses devoted to penny stock regulation. NASD estimated that in 1990[2] it devoted $19.5 million, about 11 percent of total expenses c $174.8 million, to regulation of penny stocks.

[1]Special examinations are reviews of broker-dealer operations that are done apart from the routine examination cycle. Special examinations include cause examinations, which are started as a result o customer complaints, terminations of registered representatives, or other causes, and sales practice examinations, which review broker-dealers' interactions with investors.

[2]NASD's fiscal year is the same as the calendar year.

NASD organizational units most involved in penny stock regulation are its 11 districts and its Market Surveillance and Anti-Fraud Departments, all of which are in the Compliance Division. The district offices are responsible for monitoring the financial status of member broker-dealers in their districts, examining the broker-dealers, investigating customer complaints, and implementing enforcement actions. NASD estimated that for 1990 the district offices devoted 158 staff, about 27 percent of the 596 total district office staff, to penny stock regulation. NASD's Market Surveillance Department monitors trading in over-the-counter stocks. The unit that monitors penny stock trading began with 1 staff member in 1988, had 8 staff members in 1990, and 10 staff members in 1991. The Anti-Fraud Department investigates serious sales practice abuses and any allegations of fraudulent or manipulative practices. The department had 17.5 staff years in 1988 and 36 in 1991, which were primarily devoted to investigations of the penny stock market.

Real-Time Trade Reporting Should Improve Surveillance of Penny Stock Market

Since 1986, NASD's new issue review program has been part of its surveillance of securities traded over-the-counter but not on NASDAQ. Under this program, NASD examiners monitor trading in new issues of stock to identify possible cases of market domination and associated manipulation of prices. Between 1986 and 1991, this program reviewed 212 new issues, which led to 43 Anti-Fraud Department investigations, 18 referrals to other NASD departments, and 7 referrals to other regulatory or law enforcement authorities. Of the 43 Anti-Fraud Department investigations, 11 resulted in disciplinary enforcement actions, and 3 of the 18 internal referrals resulted in enforcement actions.

Since September 1988, NASD's by-laws have required broker-dealers who trade penny stocks from their own inventory, a practice known as principal transactions, to report the highest price for which they sold each security, the lowest price at which they bought each security, and total buy and sell volume figures to NASD at the end of each trading day or early the next day. Prices for each individual trade do not have to be reported. An automated system monitors these data for any fluctuations in price and volume that exceed certain parameters. Transactions that exceed the parameters are to be reviewed by NASD staff to determine the reason for a parameter break, which could indicate abusive or violative behavior or legitimate behavior. When staff determine that there is no plausible explanation for the break, the matter is referred for further investigation by other NASD units or other regulators. From January through October 31, 1991, the system flagged approximately 3,460 parameter breaks per month.

This number was an increase from approximately 2,670 per month in 199(and 3,157 per month in 1989. From January through October 1991 (the only year statistics were available), NASD surveillance staff completed 1,14 follow-up reviews of parameter breaks. Of these, 26 led to investigations by another NASD unit outside the Market Surveillance Department or by other regulators.

The Penny Stock Reform Act requires the development of an automated system for reporting information on penny stock transactions, including trading volume and last sale prices. The required penny stock reporting system is intended to provide investors with immediate information upon which to base investment decisions. According to federal and state securities regulators, such information is important because well-informe public investors are the best weapon against penny stock fraud and abuse According to NASD, it has made necessary filings with SEC and in 1993 expects to implement a real-time reporting system for all over-the-counter securities that are not presently reported through NASDAQ. Real-time reporting means that price and volume information on the most recent trade of a security is reported on an automated system within a short time (for example, NMS and NASDAQ trades are reported within 90 seconds).

The information provided by the real-time reporting system should enhance NASD's surveillance capabilities by providing more complete data. With the advent of real-time reporting, NASD will be able to compare prices quoted on the Bulletin Board to actual transaction prices. This comparison should allow NASD to detect trades that occur at a price other than the quoted price, a practice known as "backing away." NASD rules consider "backing away" an unethical practice and require broker-dealers acting as market makers for penny stocks to trade at the price quoted on the Bulletin Board. In addition, real-time reporting will allow for the surveillance of excessive spreads. The spread is the difference between the bid and ask prices for a security and is usually rather narrow for heavily traded stocks. For those penny stocks that are not traded heavily, the market maker controls the spread and can obtain excessive profits by charging a significant percentage of the security's cost in the spread.[3]

After real-time reporting is implemented, NASD plans to start a Market Domination System. This system is designed to detect abuses commonly associated with domination and control of the penny stock market, such as excessive markups and price manipulation. According to NASD, the Market Domination System is designed to detect activity patterns of

[3]NASD uses 5 percent as a guideline for identifying possible excessive markups.

broker-dealers who dominate trading of a stock and drive the price of stock up or down.

New 800-Number Service Does Not Provide Arbitration Information

NASD's 800-number service, begun on October 1, 1991, as required by the reform act, allows investors to obtain information about any disciplinary record of their broker-dealers or the broker-dealers' sales representatives so the investors can consider that information in deciding whether to enter into a business relationship with a particular broker-dealer and its employees. SEC rules require that broker-dealers, before completing transactions in penny stocks, notify their customers of NASD's toll-free number. NASD does not charge a fee for responding to inquiries from callers planning to use the information for their personal investments. However, callers who are planning to use the information in their capacity as an agent for an investor or for other business or commercial uses are charged a $30 fee per inquiry. The toll-free number is 1-800-289-9999.

NASD's policy is to disclose information through the 800-number service on final disciplinary actions taken by NASD and other securities regulators and criminal convictions for felonies and misdemeanors involving theft, fraud, bribery, and embezzlement. According to an NASD official, NASD does not disclose customer complaints that did not result in a final disciplinary action because the complaints are unproven allegations. Also, NASD does not disclose information on arbitration awards through its 800 number because the awards are not considered disciplinary actions.

According to an NASD official, when NASD receives an inquiry, the operator completes a preliminary review to determine whether the subject of the inquiry has a reportable disciplinary history. When this review is positive, the caller is informed that a written disciplinary history will be mailed. Otherwise, the caller is informed that the subject of the inquiry has no reportable disciplinary history and the inquiry is ended. For requesters other than personal investors, a written response is also sent confirming that no reportable disciplinary history was found. According to NASD, from October 1991 through April 1992, NASD received 27,160 calls on the 800 number, an average of 3,880 monthly, and mailed out 7,902 disciplinary reports.

The Central Registration Depository, which NASD operates, is the database from which NASD extracts the reportable disciplinary information viewed by the 800-number operators when answering inquiries. Information contained in the depository is provided by NASD, SEC, some exchanges,[4] the Commodities Futures Trading Commission, the National Futures Association, state securities commissions, and the Federal Bureau of Investigation (FBI). The depository database includes about 5,500 broker-dealers and 420,000 active registered persons. An NASD official said that the operators taking the toll-free calls and making the preliminary review only see reportable disciplinary histories and not other information, such as customer complaints. Arbitration award information is not recorded in the depository but is on a separate database.

NASD realizes the importance of making arbitration information available to the public. Its by-laws state that arbitration awards involving public customers shall be made publicly available. Currently, NASD will provide anyone with written public information on arbitration awards for a $5 fee. However, this program is not well publicized and is less convenient and more costly for the investor than the 800-number service and provides information only on NASD arbitrations.

On January 19, 1993, NASD announced that the NASD Board of Governors had acted to make disciplinary and arbitration award information available over the same toll-free number. The board approved a proposal to expand the information available through the toll-free number to include civil judgments involving securities matters; pending formal disciplinary proceedings initiated by SEC, NASD, other self-regulatory organizations, and the states; criminal indictments and related information; and arbitration decisions. NASD said that it will submit the proposal to SEC for approval and expects to have the expanded information available by mid-1993.

We believe that this information is important for investors to have when choosing a broker-dealer and deciding whether to make an investment. Although arbitration awards are not necessarily disciplinary, a history of awards against a broker-dealer or one of its employees and the circumstances leading to those awards would be meaningful information to potential investors. Also, not disclosing information on arbitration awards could lead the investors to believe that no arbitration awards exist when, in fact, they do. NASD could resolve this situation by instructing its operators to inform callers that they do not have information on arbitration awards and to provide the callers with the phone number or address from which such information can be obtained. However, to learn about arbitration awards, an investor would still have to call or write NASD

[4] NYSE, Amex, the Chicago Board Options Exchange, and occasionally the Philadelphia Stock Exchange (Phlx).

at the investor's expense, ascertain that an award has been made against the broker-dealer or one of its employees, and then request the details of the award and pay the $5 fee.

NASD's Rules to Prevent Penny Stock Fraud and Abuse

Section 15A of the Securities Exchange Act of 1934 authorized NASD, with SEC approval, to promulgate rules governing members' trading and business practices. Article III of NASD's by-laws includes rules of fair practice for the business practices of members. The rules generally prohibit fraudulent, manipulative, and unfair practices and prescribe NASD policies for members, such as requiring employee supervision and establishing allowable markups on security trades. Specific rules prohibit practices that are common causes of customer complaints, such as unauthorized trades, misrepresentations, and unsuitable recommendations to buy or sell a security. To provide members with further guidance, NASD has published a Compliance Check List which is available to members for a $25 fee. NASD also provides a periodic educational circular called "Notice to Members" that further clarifies specific rules and NASD policies.

NASD Examines Members to Determine Compliance With Rules

As part of its oversight responsibilities, NASD conducts routine and special examinations of the broker-dealers, including penny stock broker-dealers. NASD schedules routine examinations in cycles of from 1 to 3 years depending on the type of business done by the broker-dealer. For example, broker-dealers that handle customer accounts and funds are to be examined every year. Brokers known as introducing brokers, who take buy and sell orders from investors and execute the trades through other broker-dealers but do not handle customer accounts or funds, are to be examined every 2 years. Brokers that only deal in certain products, such as mutual funds, and have escrow agents to hold customer accounts are to be examined every 3 years.

A complete routine examination is designed to cover both the financial operations and sales practices of the broker-dealer. The examination plan consists of several modules, or checklist-type guides with supporting analyses, each designed to test compliance with various NASD and SEC rules relating to a specific activity carried out by a broker-dealer. When NASD's routine examinations are applied to broker-dealers that trade in penny stocks, the examinations are to include questions concerning compliance with penny stock rules. NASD requires examiners in each of its 11 districts[5]

[5]NASD reduced the number of districts from 13 to 11 effective January 1, 1991, and operates 14 offices in the 11 districts.

to (1) make on-site visits to the broker-dealer they are examining, (2) complete the applicable examination modules,[6] and (3) file a report that is reviewed by a supervisor and ultimately reviewed by the district business conduct committee.

NASD also conducts special sales practice examinations as needed. Such examinations may be initiated as a result of customer complaints or as part of an off-year review of broker-dealers that are not subject to yearly routine examinations. The sales practice examinations check for excessive markups and markdowns of stock bought and sold from inventory (principal transactions), commissions on transactions in which the broker-dealer acts as a third party or agent for the investor (agency transactions), unsuitable recommendations, fraud or misrepresentations, unauthorized transactions, excessive trading, manipulation, and other sales practice violations.

NASD Generally Adhered to Examination Cycles for Penny Stock Broker-Dealers

Our analysis of NASD's routine examinations of penny stock broker-dealers showed that 34 of 40 broker-dealers on a 1-year cycle had routine examinations for each of the years 1988 through 1990. Five examinations were waived by the district directors because the previous year's examination revealed only minor problems, and one was not done because of a special examination of the broker-dealer earlier in the year. All 141 2-year cycle broker-dealers had routine examinations for 2 of the 3 years in our 1988-1990 study period. The only 3-year cycle broker-dealer also had an examination done during the 1988 to 1990 period, and NASD changed that broker-dealer to a 2-year examination cycle shortly before it was examined in 1990.

Most Financial and Sales Practice Aspects Were Covered

The two parts of examination procedures most applicable to penny stock broker-dealers are (1) financial operations, to ensure that broker-dealers are sufficiently viable to meet obligations; and (2) sales practices, to identify and discipline abusive practices. Our review of 204 NASD routine and sales practice examinations of penny stock broker-dealers completed between 1988 and 1990 in the Atlanta, Denver, and New York districts showed that most examinations included modules that covered both the broker-dealers' financial operations and sales practices, although certain portions of the modules were not always applied. As shown in table 2.1, of

[6]NASD revamped its examination modules effective July 1, 1990. Several new, specialized modules were developed that allow NASD to focus on specific areas of regulatory interest. One such module developed more extensive questions and procedures for detecting sales practice abuses, a particular concern with penny stocks.

204 examinations completed by the 3 districts, module II on financial operations was completed in 159 examinations and module T[7] on sales practices was fully or partially completed in 161 examinations. In most instances in which the modules were not completed, they were not applicable to the broker-dealer being examined. Also, when the NASD districts did not complete certain portions of the modules, it was usually because the broker-dealer did not conduct business in the subject covered by that portion of the module. However, in 19 instances, the financial or sales practice modules were not in the examination file, and the file provided no explanation of whether the modules were completed, not applicable, or waived.

Table 2.1: Coverage of Financial and Sales Practice Modules In NASD Examinations of Penny Stock Broker-Dealers In Atlanta, Denver, and New York Districts From 1988 Through 1990

Module	All 3 districts	Atlanta district	Denver district	New York district
Module II (financial)				
Applied	159	17	59	83
Not applicable	35	12	2	21
Waived	1	0	0	1
Not in file	9	0	4	5
Total	**204**	**29**	**65**	**110**
Module T (sales practice)				
Applied	161	20	60	81
Not applicable	31	9	1	21
Waived	2	0	1	1
Not in file	10	0	3	7
Total	**204**	**29**	**65**	**110**

Source: GAO analysis of NASD examination files.

Rule Violations Identified by Examinations

We collected data on the number of selected financial and sales practice violations, including rule violations involving net capital, supervision, SEC Rules 10b-10 and 15c2-6, markups, freeriding and withholding, and fraud. "Net capital" refers to SEC Rule 15c3-1, which requires that broker-dealers maintain specified levels of net worth (assets minus liabilities) and not exceed specified levels of total indebtedness. A supervision violation occurs when a broker-dealer fails to establish, maintain, and apply procedures to supervise its employees' compliance with rules. An SEC Rule

[7]Effective July 1990, module T was restructured into four separate modules addressing broker-dealers' underwriting and distributions, trading and market making, sales practices, and branch offices. Seven of the 204 exams that we reviewed used these new modules.

10b-10 violation involves a broker-dealer executing a transaction without providing the customer appropriate written confirmation of the transaction. Markup violations occur when a broker-dealer sells securities to customers at prices that are not reasonably related to the prevailing market price. "Freeriding and withholding" generally refers to the practice of withholding a portion of a new issue from the market and reselling it at prices higher than the initial offering price. An SEC Rule 15c2-6 violation involves a broker-dealer not making the required suitability determination that a customer has the experience and financial ability to invest in high-risk stocks, not obtaining customer authorization to purchase a penny stock, and not retaining the associated documentation. "Fraud" is any manipulative or deceptive practice.

As shown in table 2.2, NASD's examinations of penny stock broker-dealers in the three districts during 1988 through 1990 identified both financial and sales practice violations, but more sales practice violations. For example, of the 204 examinations, 40 had net capital violations, while 79 had supervision violations, and 69 had markup and commission violations.

Table 2.2: Number of Selected Violations Identified by Examinations of Penny Stock Broker-Dealers Completed by NASD's Atlanta, Denver, and New York Districts From 1988 Through 1990

Violation	All 3 districts	Atlanta district	Denver district	New York district
Net capital	40	0	11	29
Supervision	79	10	39	30
SEC Rule 10b-10 confirmations	45	5	17	23
Markups and commissions	69	10	31	28
Freeriding and withholding	9	0	4	5
SEC Rule 15c2-6	9	0	1	8
Other fraud	6	1	4	1

Source: GAO analysis of NASD examination files.

NASD Used Informal Remedial Actions to Correct Most Deficiencies Found on Examinations

Rule violations and operational deficiencies identified and documented by examinations provide a basis for NASD to take disciplinary action against member broker-dealers. NASD's disciplinary procedures distinguish between formal and informal actions. The district business conduct committees administer disciplinary actions following a review of the facts of an examination or other matter being considered and decide which disciplinary action is appropriate. NASD's disciplinary actions are listed with the types of situations for which they apply in table 2.3.

Table 2.3: NASD Disciplinary Actions and Applicable Situations

Disciplinary action	Applicable situation
Informal	
De minimis letter	Minor deficiencies noted during an examination that are corrected before completion of the examination.
Letter of caution	Relatively minor deficiencies for which a written corrective plan must be submitted.
Letter of future observance and compliance	Relatively minor rule infractions for which the broker-dealer details corrective action taken or to be taken.
Staff interview	Repetitive or more serious violations for which the broker-dealer must meet with NASD staff and document necessary remedial action.
Formal	
Letter of acceptance, waiver, and consent	Without admitting or denying a violation, a broker-dealer agrees to findings and sanctions and provides any needed corrective action plan.
Formal complaint	Authorized by a district business conduct committee or Market Surveillance Committee for the most serious violations, which may be resolved in an Offer of Settlement or a decision rendered after a hearing. Sanctions can be one or more of the following: (1) censure; (2) fine; (3) suspension; or (4) expulsion, revocation, or bar.

Source: NASD.

NASD's staff examiners, supervisors, attorneys, district directors, and the disciplinary committees decide what infractions are minor, relatively minor, more serious, and serious enough to warrant a disciplinary action. NASD has no detailed written guidelines about which of the disciplinary procedures should be applied to any given infraction. However, according to an NASD official, only a district business conduct committee or the Market Surveillance Committee has the power to authorize the issuance of a formal disciplinary action. When violations are considered serious enough to warrant the filing of a formal complaint, NASD has guidelines for applying sanctions, such as fines, suspensions, or barring of individuals from practice, for different violations.

On the 204 NASD examinations that we reviewed, NASD's supervisory staff seldom recommended formal disciplinary actions—the staff recommended formal complaints 20 times and letters of acceptance, waiver, and consent 10 times. The staff more frequently recommended informal remedial actions—102 letters of caution, 40 staff interviews, 15 de minimis letters, and 6 letters of future observance and compliance. On some examinations, more than one action was recommended.

NASD Policy Does Not Require Periodic Branch Office Examinations

NASD examination cycle guidance issued in February 1989 indicated that greater emphasis should be placed on examining branch offices. However, NASD has no specific plan for examining branch offices, leaving the decision to schedule special sales practice examinations of penny stock broker-dealers' branch offices to the discretion of the district directors.

For the period of 1988 through 1990, of the three NASD districts included in our review, NASD's Atlanta and New York districts provided us with examination files showing completed sales practice examinations of penny stock broker-dealers' branch offices. Our review of 204 closed examinations by NASD's Atlanta, Denver, and New York districts found that 195 were of penny stock broker-dealers' main offices, while only 9 were of branch offices. All nine of the branch office examinations were done by NASD's Atlanta district. After completion of our audit work, NASD provided us files that showed that the Atlanta district had completed the field work on an additional 26 examinations of branch offices of penny stock broker-dealers during 1988 through 1990 that were still open at the time of our review—for a total of 35 branch examinations by the Atlanta district. It provided a file to support only one examination by the New York district, which added to the Atlanta district branch office examinations amounts to a total of 36 branch office examinations. From NASD records, we identified 66 branch offices of penny stock broker-dealers located in the Atlanta district, 80 in the Denver district, and 53 in the New York district—a total of 199 for the 3 districts.

Regulators and law enforcement officials told us that penny stock fraud is often perpetrated by branch offices. Past experience has shown that examinations of branch offices often detect fraud and abuse. For example, the Atlanta sales practice examinations of branch offices of penny stock broker-dealers that we reviewed detected four cases of serious markup violations that directly led to enforcement actions and two referrals to NASD's Market Surveillance and Anti-Fraud departments for further investigation. Moreover, during special 1991 NASD and SEC examinations of branch offices that operate as franchises,[8] examiners found several

[8]Franchise offices are locations where the principal individuals of the location enter into a contractual agreement with a registered broker-dealer that allows the location to conduct a securities business under the name of the registered broker-dealer in return for a percentage of the location's profits. The franchise is supposed to operate under the supervision of the broker-dealer, and the principal individuals are required to register with SEC.

violations of rules, including (1) instances of fraudulent misrepresentation, misuse of customer funds, unauthorized trades, excessive markups, and failure to supervise; (2) unregistered broker-dealers selling securities to the public; and (3) a statutorily disqualified person functioning as a broker without being registered. Sales practice violations have also been found by SEC examiners during examinations of branch offices of penny stock broker-dealers that SEC did as part of its oversight of NASD.

NASD officials told us that NASD does not routinely visit branch offices because it covers branch offices during the main office examination. According to the officials, this coverage is generally sufficient because all of the branches' transactions are finalized by the main offices and records of the transactions are kept at the main offices. However, SEC and NASD officials also told us that with on-site examinations of the branches, NASD could better detect sales practice violations and check to see whether (1) branch office employees are properly registered, (2) employees are properly supervised, and (3) the branch is conducting business independent of the main office—all problems found during the special franchise branch office examinations. Also, individual records maintained at branch offices by the registered representatives about their deals with the public cannot be reviewed by NASD at the broker-dealer's main office.

Because of the risk of fraud in penny stock branch offices, it is important that NASD routinely examine a sufficient number of branch offices of penny stock broker-dealers, including their sales practices, in all of its districts to identify and deter abusive practices that cannot be detected at the main office.[9] NASD does not have formal standards or a plan for determining the frequency and number of branches that should be examined to adequately deter fraudulent and abusive practices. Consequently, an analysis is needed to determine how many and how often branch offices should be examined. This analysis should include a sampling plan that identifies high-risk branches in all NASD districts with branch offices of penny stock broker-dealers and the number of employees that would be required to examine the branches. To avoid diverting employees from other areas of NASD's regulatory responsibility, the analysis should consider how NASD's examination staff could be allocated within the scope of NASD's overall examination program.

[9]In July 1990, NASD introduced a special branch office examination module that incorporates questions relating to sales practices. In files of branch office examinations that we reviewed that predated the introduction of the special branch office examination module, the examiners used applicable portions of examination module T, which generally covered sales and trading practices.

Customer Complaints Are Used to Identify Violators

NASD investigates customer complaints to identify rule violations by member broker-dealers or their registered representatives in their dealings with customers. NASD procedures require that NASD acknowledge receipt of a complaint in writing and inform the customer of NASD's regulatory responsibilities, the scope of its investigation of complaints, and the availability of arbitration facilities should the customer want to seek compensatory relief. According to the procedures, NASD then provides the broker-dealer with a copy of the complaint letter and asks it to respond with specific information regarding the complaint and related matters. NASD attempts to determine whether a violation of NASD's rules of fair practice occurred. To obtain all necessary information, NASD may also telephone the customer and visit the broker-dealer.

NASD's inquiries relate only to matters that may involve a violation of securities rules and regulations and are not intended to aid the customer in seeking restitution, which is done through arbitration or the courts.

For complaints that are administrative in nature, such as securities not delivered or dividend payments not received, NASD's policy is to ask the broker-dealer to respond directly to the customer and provide NASD with a copy of the response. NASD reviews the response to see if the broker-dealer adequately addressed the complaint. When NASD is not satisfied with the response, it follows up with the broker-dealer directly to obtain more information on the details of the complaint.

From our review of customer complaint files[10] processed by NASD's Atlanta, Denver, and New York districts between 1988 and 1990, we estimated that 67 percent of the 423 complaints involved alleged sales practice violations. The estimated sales practice complaints included 116 cases of unauthorized trading in customer accounts, 60 cases of misrepresentation of an investment, 29 cases of violations of suitability requirements, and 17 cases of excessive markups and commissions. However, we were not able to determine from the files how many of the complaints involved penny stocks.

NASD investigated the complaints using several procedures, including checking the broker-dealers' or registered representatives' past employment records and any disciplinary actions, checking for other customer complaints involving the same broker-dealer, seeking the broker-dealers' position regarding the complaints, requesting relevant documents from the broker-dealers, and various other procedures. For 18

[10]See chapter 1 for an explanation of how we selected customer complaint files for review.

of the complaint files, we could not determine whether any investigative procedures had been applied.

Most complaints were filed without action. Of the 423 complaints, we estimated that 367 cases, or 87 percent, were filed without action; 18 cases, or about 4 percent, resulted in formal complaints being filed with a disciplinary committee; 15 cases, or about 4 percent, were referred to other units in NASD; 10 cases, or 2 percent, were referred outside of NASD; and for 13 cases, or about 3 percent, the final disposition could not be identified from the case files.

The customer complaints that were filed without action were closed generally because of the lack of hard evidence of any rule violation. These matters often came down to the customer's word against the broker-dealer's or the registered representative's word, without other evidence to support the claims of either party. Thus, NASD saw no basis for further action. According to SEC officials who regularly review NASD's customer complaint process, deciding how far to pursue a complaint investigation involves a lot of judgment, and SEC presently does not consider NASD's customer complaint examination process a problem.

Even though most of the customer complaints that we reviewed were filed without action, NASD officials told us that the complaints are widely used within NASD. According to those officials, NASD uses multiple complaints against the same broker-dealer to target broker-dealers for special examinations. NASD procedures require that complaint files be reviewed at the start of a routine examination and when an investigation of a broker-dealer is opened. Incoming complaints also are incorporated into any ongoing investigations of broker-dealers.

Termination for Cause Examination Effort Depends on Complete Broker-Dealer Compliance

Another type of NASD examination is called a termination for cause examination. This examination is done when a registered representative's employment with a broker-dealer is terminated. According to an NASD official, for each employee terminated, regardless of whether the employee is fired or voluntarily leaves, NASD requires broker-dealers to submit a uniform termination notice to NASD. Based on the information reported, NASD decides whether an examination is needed to determine if securities laws or NASD rules were violated by the behavior that led to the termination. When violations are found, disciplinary action can be taken against the registered representative.

Even though NASD reviews, as part of a routine examination, broker-dealers' employee files to verify that terminations were reported and can take disciplinary actions, such as those listed in table 2.3, against broker-dealers that do not report, broker-dealers are motivated not to report terminations. According to SEC, penny stock broker-dealers often do not accurately report the reasons for terminations to NASD because the broker-dealers fear that reporting could draw NASD's scrutiny and broker-dealers are concerned about any liabilities arising from civil proceedings brought against them for disclosing unproven violations. An NASD official also explained that broker-dealers are reluctant to report terminations or correctly report the circumstances of a termination because an NASD examination may result in findings of violations against the broker-dealer.

Our review identified 22 termination for cause examinations of penny stock broker-dealers completed by NASD's Atlanta, Denver, and New York districts for 1988 through 1990. The examinations resulted in eight formal complaints; one letter of acceptance, waiver, and consent; and one letter of caution. Eleven of the termination for cause examinations were filed without action, usually because no evidence of any wrongdoing was found or the affected customer would not cooperate with NASD's investigation. We could not identify the outcome of one NASD Denver district examination because sufficient documents were not in the examination file.

Sanctions From NASD Investigations Usually Offset Identified Gains of Violators

In addition to NASD's routine and special examinations, NASD's Washington, D.C.-based Anti-Fraud Department and the district offices investigate fraud and abuse and other rule violations. We reviewed the investigations of penny stock broker-dealers to document the outcomes of the investigations and determine if the resultant sanctions offset the financial gains made by the violators.

We reviewed 53 investigations that NASD's Anti-Fraud Department completed of penny stock broker-dealers and their associated persons from 1988 through May 1991. Price manipulation, excessive markups, and fraud in the offer or sale of securities were the most frequent violations investigated. Of these, the department filed 19 without action because NASD did not find sufficient evidence that a violation occurred; referred 17 cases either to NASD districts or to other authorities such as SEC or U.S. attorneys because the matters were beyond NASD's jurisdiction; and referred 17 for disciplinary actions.

We reviewed the 17 investigations that resulted in disciplinary actions to determine if the monetary sanctions resulting from those investigations offset the financial gains accrued as a result of the violative acts. Of the 12 investigations in which the financial gains were quantified, 10 had monetary sanctions—fines and disgorgements—exacted against the broker-dealers and registered representatives that exceeded the financial gains and 2 had monetary sanctions that were less than the financial gains. In one of the two cases in which the sanctions were lower than the estimated gains, the sanction to the broker-dealer was lower than estimated gains to both the broker-dealer and its employees. The Market Surveillance Committee accepted the broker-dealer's settlement offer, which exceeded the amount of money actually made by the broker-dealer but did not fully cover the amount made by its employees. However, the employees involved in the violations were suspended from practice. In the second case, the final sanction was lower than the initial estimated gain because the Market Surveillance Committee accepted the broker-dealer's settlement offer, which estimated the gain using a different accounting method to calculate excessive markups.

We also reviewed 49 investigations completed by the Atlanta, Denver, and New York districts during 1988 through 1990 to determine the extent to which the disciplinary committees imposed sanctions that were adequate to offset any financial gains. For 27 of the 37 investigations for which documents in the investigation files identified the amount of the financial gains, the sanctions rendered by district business conduct committees were greater than or equal to the excess gains. For the 10 for which the monetary sanctions were less than the gains, the committees considered mitigating factors, sanctions by other regulators, and nonmonetary sanctions, such as expulsions and suspensions, as sufficient remedial action.

Cooperative Enforcement Efforts Had Positive Results

In addition to its own surveillance, examination, and investigation functions, NASD also participates, to varying degrees, in enforcement efforts with other regulatory and law enforcement authorities. The cooperative efforts include NASD participation in task forces, providing staff assistance, and simply sharing information. Among the benefits of such efforts are avoiding duplication of effort, making the best use of each agency's particular expertise, and bringing each organization's legal authority to bear where it is most needed. Examples are given in appendix II of successful penny stock cases in which NASD was cited for providing assistance in developing the cases.

NASD Participates in SEC Penny Stock Task Forces

NASD participates at both the national and district levels in task forces designed to address issues relating to penny stocks. According to SEC officials, NASD works closely with SEC's national Penny Stock Task Force by sharing its expertise with SEC and the other regulatory bodies involved. For example, NASD staff served as instructors for two SEC training seminars on penny stock fraud that were given to prosecutors and regulators from federal, state, and international agencies.

In 1988, SEC's Miami branch office, NASD, and the Florida Securities Division organized the Florida Penny Stock Task Force following examinations of 19 penny stock broker-dealers and other information about penny stock activity. The SEC branch office had found 16 of the 19 broker-dealers in violation of federal securities laws or NASD rules. To address the problem, the task force was formed of various federal, state, and Canadian regulators, including staff from NASD headquarters and its Atlanta, Denver, and New York district offices. According to SEC, the task force was recently renamed the Florida Conference and has expanded its scope to include matters relating to securities other than penny stocks. The Florida Conference meets quarterly to discuss new programs and developments, proposed examination and enforcement activities, and specific areas of concern regarding the activities of broker-dealers.

One example of coordinated enforcement that resulted from the task force was the cold call rule (SEC Rule 15c2-6) examination sweep. For the sweep, staff from NASD, SEC, and the Florida Securities Division examined penny stock broker-dealers to determine compliance with the rule. NASD completed 82, or 44 percent, of the 188 examinations completed nationwide. SEC's February 1991 report on the sweep attributes its success to "effective, coordinated, regulatory activity involving extensive planning and communication" among the involved parties. According to the report, most broker-dealers examined were in compliance or were attempting to comply with the rule, but a significant number of violations were also found. As a result of the sweep, Florida, NASD, and SEC all brought enforcement actions against broker-dealers.

NASD Cooperation With Other Authorities

The three NASD districts that we visited cooperated to varying degrees with other state and federal regulatory authorities to share information and expertise. Staff from NASD's New York district office were regularly detailed to various law enforcement agencies to help develop penny stock cases. For example, during 1988 through 1991, district staff were detailed to assist in penny stock cases with the Manhattan District Attorney and the

U.S. Attorneys for the Southern and Eastern Districts of New York and for New Jersey. The NASD staff generally provided advice on securities laws and helped develop evidence. Officials of the law enforcement agencies with whom we spoke said that NASD staff were instrumental in developing the cases.

The NASD Atlanta district has provided schedules of broker-dealers' price markups and other information to state and federal agencies. NASD Atlanta district staff also participated in joint field examinations with the SEC Miami branch office. According to an NASD district official, district examiners have never been detailed to work with other federal or state agencies in an investigation of a penny stock broker-dealer. The official said that they seek extra short-term assistance from a state or federal agency on an as-needed basis and this arrangement has worked well for them.

The NASD Denver district office has worked with several state regulatory agencies, including those of Colorado, Utah, and Arizona. Such joint efforts were undertaken on a case-by-case basis and usually concerned cases of a criminal or fraudulent nature. According to NASD district officials, the district works with state agencies more often than with federal agencies such as SEC, the FBI, and U.S. attorneys. The district officials told us that the offices of those federal agencies in the Denver region are reluctant to share information with NASD because NASD is a self-regulatory organization. FBI officials confirmed this, saying that they had not shared information with NASD's Denver district office because the district business conduct committee had penny stock broker-dealers as members. In 1989, for example, 7 of the Denver district business conduct committee's 10 members were from broker-dealers identified by NASD and SEC as penny stock broker-dealers. NASD has restructured the district so that it now covers 10 rather than 5 states, which provides the district with a more diverse mix of broker-dealers. As a result, only 1 member of the 16-member committee for 1991 was from a penny stock broker-dealer.

NASD Participates in Department of Justice Efforts

Staff from NASD's Anti-Fraud Department also serve on the Department of Justice's Securities and Commodities Fraud Working Group. This group functions primarily as an information sharing body. NASD staff have assisted the group in collecting information and in reconstructing trading or market situations.

One potential area where officials of U.S. attorneys offices and the FBI told us cooperation could be improved involves NASD's discretion over which potential violations of criminal statutes it refers to the FBI or U.S. attorneys. While the law enforcement officials did not mention specific cases in which violations should have been referred but were not, they also had no way of knowing how many such cases exist. They said that a formal procedure should be established for direct referral to federal law enforcement authorities of suspected criminal violations identified by NASD examinations. Such criminal referral procedures have been established for the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation to report instances of suspected violations of a criminal statute discovered during bank examinations.

NASD officials said that such a procedure would not be consistent with NASD's role as a self-regulatory, nongovernmental, private membership organization. NASD said that its separation from government is critical to maintaining its ability to enforce its rules over its members. According to NASD, members are required to make all their business records available to NASD examiners, and the members may be less willing to make all records available if they know that information may be routinely sent to law enforcement agencies. A formal referral system, they said, could raise constitutional protection issues and could result in an administrative burden for NASD staff without any direct increase in benefits. According to NASD, the present system, under which matters are referred based on the judgments of NASD attorneys and managers, has been effective, and NASD encourages ongoing voluntary coordination with other regulatory and law enforcement authorities.

Penny Stock Problem Is Not Resolved

NASD's application of its various detection and enforcement procedures during recent years has resulted in many enforcement actions against penny stock broker-dealers. While we did not question the appropriateness of NASD's disciplinary decisions, our analysis of NASD enforcement actions that involved penny stocks shows that from 1988 through 1991, NASD's disciplinary committees censured[11] penny stock broker-dealers and associated persons 216 times, fined penny stock broker-dealers and associated persons $18.4 million, expelled 29 penny stock broker-dealers from membership, barred 74 individuals from

[11]A censure is an official reprimand for violative acts or practices and, in the securities industry, is regarded as a serious sanction.

practice as a broker-dealer or registered representative,[12] and temporarily suspended 98 broker-dealers and registered representatives from practice in the securities industry. During 1988 through 1991, NASD's disciplinary committees also required restitution of $4.3 million of excess profits to investors.

As shown in appendix III, in recent years NASD has also made several improvements in its operations and procedures for regulation of broker-dealers who trade in penny stocks. Despite these efforts, complaints about penny stock abuses are still received regularly from investors. Law enforcement officials told us that perpetrators of fraudulent schemes modify their approaches quickly in response to new regulations and enforcement actions so that constant revisions to regulatory oversight are necessary. These officials said that the same type of schemes that occur in the penny stock market are also occurring with stocks that are selling for slightly more than $5 per share. NASD officials said that cases are under review that involve securities priced above $5 and that it closely monitors the securities sold by penny stock broker-dealers to detect any change in product mix and pursue any questionable activity.

Conclusions

NASD employs several techniques to oversee its broker-dealer members' activities in the penny stock market. To combat recent prevalent penny stock fraud and abuse, NASD has increased efforts to oversee trading in penny stocks, investigated fraudulent practices, and disciplined violators. NASD has supplemented these efforts by working in cooperation with federal and state authorities.

NASD's overall penny stock enforcement efforts have shown positive results in terms of enforcement actions against penny stock broker-dealers and their associated persons. However, fraud and abuse involving penny stocks continue and may be taking on new characteristics in response to recent increased enforcement efforts and new rules. Securities regulators, therefore, must continue to be on guard against highly innovative perpetrators of penny stock fraud and, if necessary, be prepared to make additional efforts.

Past enforcement efforts have found that penny stock fraud and abuse are prevalent at branch offices of broker-dealers. While NASD had examined many branch offices in its Atlanta district, it did not routinely examine branch offices of penny stock broker-dealers during 1988 through 1990 in

[12]A registered representative is any associated person of a broker-dealer that is registered with NASD.

the Denver and New York districts, which have many branch offices of penny stock broker-dealers. NASD has no specific plan for examining branch offices. We are concerned that by not making on-site visits to high-risk branch offices, NASD may be missing sales practice violations that cannot be detected at broker-dealers' main offices. Site visits to the branch offices of penny stock broker-dealers would also allow NASD to verify whether branch employees are properly registered, whether employees are being properly supervised, and whether the branches are conducting unreported or inappropriate business independent of the main office.

We are also concerned that NASD's toll-free phone service policy of not providing investors with information on arbitration awards may not provide them with sufficient information to make informed investment decisions. NASD recognizes the importance to investors of arbitration information in deciding whether to conduct business with a broker-dealer and provides arbitration award information under another program. However, that program is not as well known as the toll-free service, is more burdensome, and requires the investor to pay a fee.

Recommendations

We recommend that the Chairman, SEC, require NASD to

- provide public investors who request information via NASD's toll-free phone service with information on final arbitration awards; and
- develop a plan for examining the branch offices of penny stock broker-dealers in all NASD districts that includes a sampling plan to identify high-risk branches, establishes the frequency of examinations, and determines the number of employees required to examine branches.

Agency Comments and Our Evaluation

SEC concurred with our recommendations. SEC said that the public should be able to learn of final arbitration awards by calling NASD's 800 number and will work with NASD to accomplish this objective. SEC said that NASD should develop a plan for examining branch offices of penny stock broker-dealers and that NASD efforts in this area should be designed to identify the branch offices of these broker-dealers that present the greatest risks to the investing public. SEC said that it will meet with senior NASD staff to discuss cost-effective ways in which NASD can address our recommendations. SEC suggested technical changes, which we made where appropriate.

NASD said that a draft of this report represented a fair and balanced presentation of NASD's regulatory and enforcement initiatives in the penny stock area. NASD suggested that various supplemental information be included in the final report, which we referred to where appropriate and included in total in appendix V.

NASD said that it is actively considering plans to provide the public with the ability to obtain both disciplinary and final arbitration information through the same toll-free number. NASD believes that this action, when done, will fully respond to our first recommendation. As noted, in January 1993, NASD's board approved a proposal to provide arbitration award and other information via the toll-free service. We commend NASD's decision to request SEC's approval to make arbitration award information available over the toll-free service.

NASD said that our reference to nine examinations completed on branch offices of penny stock broker-dealers was inaccurate. We identified the nine examinations from an NASD-compiled list of "closed" examinations provided to us in June 1991. After reviewing a draft of this report, NASD provided us files for an additional 27 examinations of branch offices of penny stock broker-dealers—26 in the Atlanta district and 1 in the New York district—that had been completed during 1988 through 1990, but not officially closed at the time of our field work.

NASD noted that it has no specific cycle established to examine branch offices, but that each district annually establishes a program of special branch office sales practice examinations. NASD also referred to a 1990 program of special examinations of franchise branch offices of penny stock broker-dealers. While we find these special efforts to examine branch offices commendable, we believe that the positive results of these efforts provide support for our recommendation that NASD develop a plan for regular examinations of high-risk branch offices of penny stock broker-dealers. Serious markup violations found by the Atlanta district and violations found by special examinations of franchise branch offices indicate to us that branch office examinations are needed to detect violations in all NASD districts with branch offices of penny stock broker-dealers.

New Rules and SEC Oversight of Exchange Listing Practices Diminish Concern Over Avoidance of Penny Stock Regulation

Before April 28, 1992, when SEC's new rule revising its definition of penny stocks was adopted, companies that issued penny stock could avoid penny stock designation and regulation if they were able to list the stock on a securities exchange or on NASDAQ.[1] To list their stocks on these markets, companies had to meet certain requirements designed to ensure that only legitimate companies are listed. For example, NYSE requires that a company have at least 1.1 million publicly held shares of stock with an aggregate market value of $18 million, and Phlx requires at least 250,000 publicly held shares worth at least $500,000 in addition to other requirements. Once listed, companies also must meet minimum standards known as maintenance requirements to remain listed.

According to SEC officials, the rationale for excluding exchange-listed stocks from penny stock designation was that the companies that could meet exchange requirements would be established companies that would most likely not be part of penny stock scams. Historically, the most troublesome penny stocks have been issued by "shell companies" with scant assets and few public stockholders. In addition, exchange-listed stocks would be under the scrutiny of exchange market surveillance programs.

In response to congressional concern that some penny stock market makers may evade penny stock laws and regulations by having the companies list their stocks on regional exchanges but then trade the stocks in the over-the-counter market, we reviewed exchange listing and delisting requirements and procedures for February 1989 to September 1991. Because of concerns that were expressed by some exchanges about treating all exchanges equally, we included Amex, NMS, and NYSE in our study even though their listing requirements greatly exceeded the regional exchanges' and NASDAQ's requirements.

We found that four of the seven exchanges we reviewed allowed variances from their listing requirements for some companies listed during that period. The other three exchanges either had policies that permitted variances or consider special circumstances when making listing decisions. Flexible interpretation and application of exchange listing and delisting requirements combined with competition among the exchanges for listings, as the exchanges vie for more listings and the attendant listing

[1]In this chapter, for simplicity of presentation, the word "exchange" will be used to refer to the primary stock exchanges, including the Amex and NYSE, regional stock exchanges including BSE, PSE, and Phlx, as well as NASD's NASDAQ and NMS interdealer quotation services. We recognize that NASD is a registered securities association and not a national securities exchange as defined by law and regulation.

fees, could lead to overall erosion of the requirements. However, SEC recently started a program for regular periodic inspections of the exchanges' listing functions that, if done properly, should help alleviate future concern regarding listing practices. Further, penny stock rules adopted in April 1992[2] exclude from the definition of penny stocks only those regional exchange stocks that are listed and traded on the exchanges or meet NYSE and Amex listing requirements. This change should alleviate concerns about penny stock issuers listing on regional exchanges to avoid regulation, because, according to SEC officials, the stocks would be subject to the exchanges' surveillance programs and penny stock issuers should be unable to meet the more stringent NYSE and Amex requirements.

We did not review the listing procedures applicable to the Emerging Company Marketplace, which Amex introduced on March 18, 1992, because we were near completion of our audit work when it began operations. According to Amex officials, the Emerging Company Marketplace is intended to compete directly with NASDAQ for listings and enhance Amex's ability to attract stocks that will "graduate" to regular Amex listings when they qualify. The Amex officials said that there would be no variances allowed for the Emerging Company Marketplace. In addition, they said that all of the market surveillance procedures applied to regular Amex listings, including last sale price and volume reports and audit trail features, will be applied to the Emerging Company Marketplace.

Exchange Listing Procedures Are Similar

Listing procedures differ slightly from exchange to exchange but in general follow a similar process. First, the exchange receives the initial listing application and accompanying documentation, including a prospectus of the offering, the company's latest annual report, and various SEC-required public filings.[3] Next, exchange staff review the application

[2]New SEC rules adopted in April 1992 to implement the Penny Stock Reform Act of 1990 define the term "penny stock" to exclude any "reported securities" for which last sale reports are collected and made available according to a transaction reporting plan. "Reported securities" include securities listed on NYSE, Amex, and NMS as well as regional exchanges when the securities meet NYSE or Amex listing requirements. NASDAQ securities and securities that are both listed and traded on regional exchanges are also exempt from the rules. The new SEC rules also exclude Amex's Emerging Company Marketplace securities from definition as penny stocks except as they relate to Section 15(b)(6) of the Securities Exchange Act of 1934, which gave SEC the authority to prohibit any person who has engaged in unlawful conduct while participating in the distribution of penny stocks from associating with a broker-dealer or participating in a distribution of penny stock if SEC finds that such a restriction will be in the public interest. NASDAQ and regional exchange-listed companies are also subject to Section 15(b)(6).

[3]Filings include forms 10K, 10Q, 8A, S-1, and S-18. These reports contain financial data and corporate governance information as well as background about the firm's history and management.

material for completeness and accuracy and determine whether the applicant meets the listing requirements. When listing requirements are not met, the staff may analyze additional factors to decide whether a variance from the requirements should be granted. The staff then presents to the exchange listing committee the application package with a staff recommendation regarding whether to list the issue and the rationale behind the recommendation, especially in cases in which the applicants may fail to meet one or more of the requirements. On the basis of the information presented, the committee decides whether to list the stocks. Finally, staff notify the companies of acceptance and bill them for listing fees. The companies must also pay annual fees to remain listed. Some exchanges, such as NYSE, have preliminary reviews to determine a company's acceptability before sending it an application package; once the company is invited to apply, the application process is merely a formality.

Exchanges Allow Variances

Most of the exchanges, including Amex, BSE, NASDAQ, NMS, Phlx, and PSE, had listing requirements in force during the review period that could be waived. For example, Amex's listing requirements state that "the fact that an applicant may meet the Exchange's numerical guidelines does not necessarily mean that its application will be approved. On the other hand, an application may be approved even though the company does not meet all of the numerical guidelines." NASD's NASDAQ and NMS listing requirements also permit variances from the requirements stating that NASD may make "exceptions to its requirements where it deems appropriate." NYSE officials also told us that, while its listing requirements do not permit variances, it will consider unusual circumstances, such as the effects of a leveraged buyout or debt repayments on past or future financial results, when viewing a company's demonstration that the requirements are met. Officials of BSE and PSE, which have filed proposed rule changes to revise their listing requirements, said that the new requirements will be interpreted as standards that will be strictly enforced. Phlx has also proposed a rule change that advocates stringent application of the new listing requirements.

Our review of the exchanges' files for new listings from February 1989 through September 1991 showed that all of the NYSE-, NASDAQ-, and NMS-listed companies that we reviewed met their listing requirements.[4] We also found cases in which Amex, BSE, Phlx, and PSE allowed variances from listing requirements by accepting issues for listing even though they did

[4]The review period for NASDAQ and NMS was February 1989 through December 1990. The number of records reviewed at each exchange and our sampling procedures are described in chapter 1.

not meet the exchanges' formal stated requirements. However, the exchanges generally provided reasons for the variances. For example, one exchange listed a company that did not meet its requirement for stockholders' equity and minimum value of publicly held shares. The company was listed because its pretax income for the previous year was twice the exchange's requirement and because stock prices for the industry, which had been in a slump, were expected to pick up. Some of the variances were small and considered de minimis by the exchanges. We had no basis for evaluating whether the variances were appropriate.[5] The results of our review of the exchanges' adherence to listing requirements are shown in table 3.1.

Table 3.1: Exchange Listings and Delistings for February 1989 Through September 1991

Exchange	Listings	Met listing requirements	Delistings	Delisted for not meeting requirements
Amex	167	115	212	79
BSE	60	53	43	28
NASDAQ	410	410[a]	695	512[a]
NMS	165	165[a]	273	262[a]
NYSE	340	340[a]	210	91[a]
PSE	17	15	25	25
Phlx	11	1	16	16

Note: Review period for NASDAQ and NMS was February 1989 through December 1990.

[a]Estimate. The 95-percent confidence intervals for the estimates of the number of listings which met listing requirements are 402 to 410 for NASDAQ, 159 to 165 for NMS, and 329 to 340 for NYSE. The 95-percent confidence intervals for the estimates of the number of delistings that were delisted for not meeting requirements are 470 to 554 for NASDAQ, 254 to 267 for NMS, and 77 to 105 for NYSE.

Source: GAO analysis of exchange listing and delisting documents.

[5]A July 1992 report by the California Department of Corporations on the listing practices of Amex, NMS, and NYSE indicates 16 instances where Amex granted variances from its listing requirements, 36 instances where NMS granted variances, and 48 purported instances where NYSE granted variances. NYSE reviewed each of the purported variances and concluded that variances were not granted. NYSE responded that the listings were consistent with NYSE's policy of considering listing candidates' demonstrated current financial operations even though those demonstrations may differ from the companies' publicly reported operating results.

Exchange Delisting Procedures Are Similar

As with listing procedures, delisting procedures differ among exchanges but generally follow a similar process. All listed companies must file periodic disclosure reports with the exchanges. Staff review these reports to ensure timely filing and monitor financial and other relevant information about the companies. At some exchanges, such as NASDAQ and PSE, data from the reports are entered into automated systems that print out names of firms that fall below maintenance parameters. When a company fails to meet one or more of the maintenance requirements, exchange staff are to contact the firm and elicit from company management a plan and time frame for taking remedial action to bring the firm back into adherence with the requirements. Exchange staff forward this information to a committee that decides whether to delist the company or grant it additional time to meet maintenance requirements.

Companies Delisted for Not Maintaining Standards

To verify that the exchanges were delisting issuers for not meeting maintenance requirements, we reviewed records of firms delisted between February 1989 and September 1991. All of the exchanges delisted issuers for various reasons, frequently for not meeting maintenance requirements. Reasons for delisting that were related to maintenance requirements included insufficient financial amounts (such as net tangible assets or earnings), insufficient shares outstanding or insufficient shareholders, not filing required information in a timely manner, filing for bankruptcy, or having too few market makers. Reasons for delisting that were not related to maintenance requirements included acquisition by, or merger with, another firm; redemption or expiration of stocks or warrants; and company requests to cease listing on an exchange. We did not determine whether the exchanges delisted all firms that failed to meet maintenance requirements. The results of our review of exchange delistings are shown in table 3.1.

SEC Now Inspects Exchange Listing Functions

During 1991, SEC started an inspection program of exchange listing and maintenance activities. According to SEC, it plans to inspect all exchanges in a 3-year cycle. As of June 1992, SEC had completed inspections of three stock exchanges—Phlx, PSE, and BSE. In fiscal year 1993 and early 1994, SEC plans to inspect NASDAQ and NYSE, followed by Amex. During the inspections, SEC reviews the exchanges' listing and delisting procedures and how well the exchanges adhere to their listing and maintenance requirements. After the inspection, SEC prepares a written report to the exchanges noting any deficiencies and remedial actions necessary. While we did not review the

SEC program, this oversight of exchange listing and maintenance practices should help prevent overall erosion of the requirements.

Conclusions

Our review of exchange listing requirements and application files for February 1989 through September 1991 showed variances from the listing requirements for four of the seven exchanges we reviewed. The other three exchanges either had policies that permitted variances or consider special circumstances when making listing decisions. Flexible application of listing requirements could lead to overall erosion of the requirements. While competition among exchanges for listings encourages exchanges to waive their listing requirements, SEC's continued oversight inspections of the exchanges' listing functions should help prevent overall erosion of the requirements. Further, SEC's new definition of penny stocks should help prevent attempts by penny stock issuers to evade regulation by listing on the regional exchanges. In addition, BSE, Phlx, and PSE said that their requirements will be strictly applied in the future.

Exchange Comments

We provided each of the exchanges and NASD the opportunity to comment on and discuss the contents of this chapter. Amex, BSE, NYSE, and PSE generally agreed that the information presented is accurate. We made technical changes where appropriate. NASD and Phlx had no comments on this chapter.

Summaries of Selected SEC and NASD Rules Affecting Penny Stock Trading and Sales Practices

SEC Rule[a]	Requirement
3a51-1	Rule defines the term penny stock to exclude certain equity securities. In general, the rule excludes any security that is a reported security (security for which last sale reports are collected and made available pursuant to an effective transaction reporting plan), except that a security that is registered on Amex pursuant to the listing criteria of the Emerging Company Marketplace is considered to be a penny stock solely for the purposes of Section 15(b)(6) of the Securities Exchange Act of 1934. Securities listed on NYSE and Amex (except Emerging Company Marketplace securities), as well as securities that meet NYSE or Amex listing standards that are listed on the regional exchanges, are reported securities for purposes of this rule. Also excluded from the definition is any security that is registered or approved for registration on a national securities exchange that makes transaction reports available pursuant to Rule 11Aa3-1, provided that (1) current price and volume information with respect to transactions in that security is required to be reported and is made available to vendors pursuant to the rules of a national securities exchange and (2) the security is purchased or sold in a transaction on or through the facilities of a national securities exchange or as part of the distribution of the security. Also excluded is any security that is or will be authorized upon notice of issuance for quotation on NASDAQ. A security with a price of $5 or more is also excluded from the definition. The rule also excludes penny stocks for which the issuer has either (1) net tangible assets of $2 million if that issuer has been in continuous operation for at least 3 years, or $5 million if the issuer has been in continuous operation for less than 3 years; or (2) average revenue of at least $6 million for the last 3 years. The required level of net tangible assets or revenues must be demonstrated by current audited financial statements that the broker-dealer has reviewed and has a reasonable basis for believing are accurate. Finally, the rule excludes from the definition securities that are issued by an investment company registered under the Investment Company Act of 1940 and put and call options issued by the Options Clearing Corporation. (Effective April 28, 1992.)
10b Series	Rule prohibits manipulative and deceptive practices and contrivances in the trading of securities. (Various rules adopted and amended since 1938.)
15c2-6	Broker-dealers who recommend purchases of penny stocks to persons who are not established customers must make a documented suitability determination regarding the purchaser and obtain the purchaser's written permission for the first three purchases of penny stocks. (Effective January 1, 1990.)
15c2-11	Broker-dealer must obtain, maintain, and review specific information about the stock issuer before entering any quotations in any medium. (Effective in present form January 14, 1985.)
15g-1	Certain transactions are exempt from the broker-dealer disclosure requirements of Rules 15g-2 through 15g-6. Transactions are exempt if (1) broker-dealers derive less than 5 percent of their revenues from the sale of penny stocks for which they have not acted as a market maker for the preceding 12 months; (2) the customer is an institutional accredited investor; (3) transactions meet the requirements of Regulation D or are exempt from the registration requirements of the Securities Act of 1933 pursuant to Section 4(2) of that act; (4) the customer is the issuer or a director, officer, general partner, or direct or indirect beneficial owner of more than 5 percent of any class of equity security of the issuer of the penny stock that is the subject of the transaction; or (5) the transaction was not recommended by the broker-dealer. (Effective April 28, 1992.)
15g-2	Broker-dealer must provide a standardized risk disclosure document to the customer before effecting any penny stock transactions. (Effective July 15, 1992.)
15g-3	Broker-dealer must disclose before transaction and after the confirmation to the customer current quotation prices or similar market information before effecting any penny stock transaction. (Effective January 1, 1993.)
15g-4	Broker-dealer must disclose to the customer the aggregate amount of any compensation received in connection with a penny stock transaction, both before effecting the transaction and at or before the time the confirmation is sent to the customer. (Effective January 1, 1993.)

(continued)

SEC Rule[a]	Requirement
15g-5	Broker-dealer must disclose and subsequently confirm cash compensation received by most associated persons who have communicated with the customer concerning the transaction, both before effecting the transaction and at or before the time the confirmation is sent to the customer. (Effective January 1, 1993.)
15g-6	Broker-dealer must provide the customer with monthly account statements that disclose the identity and number of shares of each penny stock held in the customer's account and the estimated market value of the security, based on the highest inside bid quotation on a qualifying electronic quotation system or recent purchase by that broker-dealer, if available. The statement must also contain a standardized legend in which estimates of market value used on the statement are explained. (Effective January 1, 1993.)
Rule 419	Funds received and securities issued in a blank check offering of penny stocks must be placed in an escrow account until consummation of the acquisition(s), whose fair market value represents at least 80 percent of the maximum offering proceeds. (Effective April 28, 1992.)
15g-8	Rule prevents trading of securities held in a Rule 419 account. (Effective April 28, 1992.)
NASD Rule	
Best Market	Broker-dealer must, before executing a transaction in an over-the-counter security that is not listed on NASDAQ, contact and obtain quotations from a minimum of three dealers and note on the customer's order ticket both the identities of the dealers contacted and the price quotations received to determine the best interdealer market.
Markup/Markdown	Markups/markdowns should normally not exceed 5 percent of the prevailing market price for equity securities.
Schedule H	Broker-dealer must report its principal transactions in over-the-counter securities that are not listed on NASDAQ at the end of each trading day or early the next day (reporting the symbol, daily volume, highest sale price, lowest purchase price, and whether those trades were with a customer or another broker-dealer). A broker-dealer seeking to initiate or resume quotation of an over-the-counter security that is not listed on NASDAQ must provide NASD with financial and other information as required by SEC Rule 15c2-11 and also disclose its basis for making price quotations.
Firm Quotation	Quotations for domestic securities must be firm (traded at the quoted price) for at least 1 trading unit (100 shares).
Rules of Fair Practice (Article III, sections 1-43)	Rules require generally that all practices in connection with investment banking and securities business shall be just, reasonable, and not unfairly discriminatory. Rules prohibit numerous abusive trading and sales practices.

[a]Actual rules are very technical and should be consulted directly for specific requirements. Several of the rules, such as SEC's Rule 10b series and NASD's firm quotation requirement, are not unique to penny stocks.

Selected Penny Stock Cases in Which NASD Was Recognized for Providing Assistance

- The U.S. Attorney for the District of New Jersey recognized NASD's assistance in bringing indictments relating to a $67 million penny stock manipulation scheme. The indictment named four former owners of a major penny stock broker-dealer.
- SEC's Enforcement Division recognized NASD for assisting in a civil injunction action against 24 defendants. The action alleges that the various defendants participated in a number of violations, including (1) knowingly and recklessly inducing customers to invest in selected penny stocks through false or misleading statements, (2) making investment recommendations without a reasonable basis, (3) charging customers fraudulently excessive markups, and (4) carrying out a securities price manipulation scheme.
- The U.S. Attorney for the District of New Jersey recognized NASD for assisting in a case in which four principals and employees of a now defunct Florida penny stock broker-dealer pleaded guilty to the manipulation of three penny stocks. The defendants could face from 5 to 15 years in federal prison and fines ranging from $250,000 to $750,000.
- The U.S. Attorney for the District of Rhode Island recognized NASD for assisting in securing a guilty plea against a person who, acting on behalf of a broker-dealer, fraudulently induced 44 individuals to invest $1.4 million with him. The defendant faces a maximum penalty of 10 years in prison and a fine of $1 million. NASD also expelled the individual from membership, fined him $1.5 million, and censured him.
- In a case concluded in January 1992, the U.S. Attorney for the District of New Jersey announced that the owner and president of a penny stock broker-dealer pleaded guilty to wire, mail, and securities fraud and faced a maximum of 20 years in prison and fines up to $250,000. The U.S. Attorney credited NASD's New York district office and the Anti-Fraud Department, along with other regulators and law enforcement agencies, with developing the case.

List of Selected Operational Changes NASD Made to Improve Penny Stock Regulation

- In 1986, NASD began a new issue review program to detect fraud and manipulation in new stock issues.[1]
- In 1988, NASD began using one analyst in its Market Surveillance Department to monitor trading in over-the-counter securities that are not listed on NASDAQ or NMS. By 1991, this effort had grown to a separate section with 10 positions.
- In September 1988, NASD began requiring broker-dealers that trade in over-the-counter stocks that are not listed on NASDAQ or NMS to report trading prices and volumes to NASD at the end of each trading day on NASD's Schedule H reports.
- In March 1989, NASD surveyed branch offices of broker-dealers to identify characteristics of securities-related activities in which the branches were engaged. This information was used in amending NASD's rules of fair practice concerning members' supervision of registered representatives.
- From 1988 to 1991, NASD increased staff years in its Anti-Fraud Department from 17.5 to 36 positions.
- In June 1990, NASD began operating the Over-The-Counter Bulletin Board, a real-time price quotation system for over-the-counter securities that do not meet NASDAQ listing requirements.
- In July 1990, NASD instituted revised examination modules designed to focus on potentially serious sales and trading practice violations and has placed greater emphasis on penny stock broker-dealers in the examination process.
- In May 1991, NASD again surveyed the branch offices to identify those that actually were franchise operations. NASD and SEC then examined the franchises.
- Late in 1991, NASD began operating the toll-free telephone service required by the Penny Stock Reform Act. The service is intended to allow investors to obtain information on a broker-dealer's and its employees' disciplinary history.

Note: Information obtained from NASD officials and documents provided by NASD.

Comments From the Securities and Exchange Commission

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

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

DIVISION OF
MARKET REGULATION

November 27, 1992

Richard L. Fogel
Assistant Comptroller General
General Government Division
General Accounting Office
Washington, D. C. 20548

Re: GAO Penny Stock Report

Dear Mr. Fogel:

I am writing in response to your request for comments by the Securities and Exchange Commission ("Commission" or "SEC") on the General Accounting Office's ("GAO") draft report entitled Penny Stocks: Regulatory Actions to Reduce Potential for Fraud and Abuse. The draft report concludes that the enforcement actions against penny stock broker-dealers and their associated persons have shown positive results. Nevertheless, the GAO believes that the potential for fraud and abuse remains high, and that securities regulators must be on guard against highly innovative perpetrators and be prepared to make additional efforts.1/

The draft report makes two specific recommendations to the Commission. First, the draft report recommends that the Commission require the National Association of Securities Dealers, Inc. ("NASD") to provide public investors who request information on the NASD's toll-free phone service with information on final arbitration awards. Second, the draft report recommends that the Commission request the NASD to develop a plan for examining the branch offices of penny stock broker-dealers, and for such plan to include a method for identifying high risk branch offices, to establish the frequency of branch office examinations, and to determine the amount of resources required to examine branches.

I appreciate the opportunity to provide you with our comments relating to the draft report, and to address the specific recommendations suggested in the draft report. I also would like to take this opportunity to express our appreciation for the cooperation and professionalism extended by your staff during their review of the Commission's and the NASD's program initiatives and efforts to combat the sales practices abuses in the sales of low-priced securities.

Now on p. 47.

1/ Draft Report at p. 57.

A. Recommendations

We concur with and support the draft report's recommendations that the NASD's toll free phone service provide information on final arbitration awards, and that the NASD develop a plan for examining branch offices.

1. NASD 800 Telephone Number

Section 509 of the Enforcement Remedies and Penny Stock Reform Act of 1990 requires the NASD to implement an 800 telephone listing to receive inquiries from the public concerning disciplinary information about registered firms and individuals. In this regard, we note that final arbitration awards are not, strictly speaking, disciplinary information. Nevertheless, the Division of Market Regulation agrees with the GAO recommendation that the public should be able to learn of final arbitration awards 2/ by calling the NASD's 800 number and will work with the NASD to accomplish this objective.

2. Formal Plan for the Examination of Penny Stock Broker-Dealer Branch Offices

Although we believe that the NASD's primary objective should be to routinely examine the main offices of penny stock broker-dealers, we concur with the GAO recommendation that the NASD should develop a specific plan for examining branch offices of penny stock broker-dealers. In this regard, we believe the NASD's efforts in this area should be designed to identify the branch offices of these firms that present the greatest risks to the investing public. We will be meeting in the near future with senior NASD staff to discuss cost effective ways in which the NASD can address this recommendation.

Our remaining comments are directed to providing editorial or clarifying comments to the following:

B. Executive Summary

1. Results in Brief

See comment 1.

The reference in the last sentence of the second paragraph on page 3 that the NASD "...has not fully implemented the regulatory improvements required of it.", needs to be clarified. We understand from a discussion with a GAO staff person that the required improvements actually refers to the NASD's

2/ Although NASD arbitration awards have been publicly available since the Commission approved an NASD rule change in May 1989, investors calling the NASD 800 number are not told of arbitration decisions.

anticipated implementation of a real-time reporting system for all over-the-counter securities in early 1993.

See comment 2.
Now on p. 5.

The reference in the last paragraph on page 4 that the NASD's periodic on-site visits to branch offices could "...determine whether branch employees are properly registered with SEC...", should be changed to reflect that branch employees are properly registered with the NASD. The SEC only registers broker-dealers, while the NASD registers employees as associated persons of registered broker-dealers.

C. **Chapter 1**

1. <u>History of Penny Stocks</u>

Now on p. 21.
See comment 2.
Now on p. 42.
See comment 2.

The reference in the last sentence of the first paragraph on page 20 should be changed from "...according to a SEC official," to "...according to the SEC". Similarly, the reference in the second sentence of the last paragraph on page 49 should be changed from "... According to an SEC penny stock task force official" to "According to the SEC." The entire draft report speaks generically of only the NASD and the SEC, except for the reference to an SEC official here and a similar reference at page 49. Also, the reference to "...25 percent of SEC's penny stock investigations now involve foreign countries." should be changed to "... 20 percent of SEC's penny stock investigations now involve a person or entity from a foreign country."

Now on p. 20.
See comment 3.
See comment 2.

The reference at the top of page 21 to 165 active penny stock broker-dealers in June 1992, should be changed to 178 according to a June 8, 1992 report. Additionally, footnote 11 needs to be qualified. Although the SEC's penny stock list includes firms that do not, generally, have a retail customer base, these clearing firms and wholesale market making firms are included on the list because these firms can potentially play a role in any scheme to manipulate the market for low-priced securities.

D. **Chapter 2**

1. <u>New 800-Number Service Does Not Provide Arbitration Information</u>

Now on p. 31.
See comment 2.

The reference at the third paragraph on page 34 of the draft report refers to the Central Registration Directory. The reference to Directory is incorrect and should be changed to Depository.

2. Termination For Cause Examination Effort Depends On Complete Broker-Dealer Compliance

Now on p. 42.
See comment 2.

The reference at the second paragraph on page 49 relating to the SEC 's comment that "... penny stock broker-dealers often do not accurately report the reasons for terminations to NASD because the broker-dealers fear that reporting could draw NASD's scrutiny.", should also state that NASD member firms also are concerned about potential liabilities arising from civil proceedings brought against them for disclosing allegedly unfounded violations or misconduct by individual registered representatives.

E. Appendix I

1. Summaries of Selected SEC and NASD Penny Stock Rules

See comment 4.

The reference to penny stock in the above title should be deleted, inasmuch as several of the rules defined in Appendix I are not unique to penny stock regulation.

We appreciate the opportunity to comment on the draft report. We would, of course, be happy to meet with GAO staff to discuss our comments further. If you have any questions regarding this letter, please feel free to telephone me at (202) 272-3000 or Mark Fitterman at (202) 272-2830.

Sincerely,

William H. Heyman
Director

The following are our comments on SEC's November 27, 1992, letter.

GAO Comments

1. Text deleted because it is now 1993.

2. Text modified.

3. Although SEC's June 8, 1992, report shows 178 penny stock broker-dealers, we use a more recent report by SEC's Office of Economic Analysis that shows 165 penny stock broker-dealers as of the end of June 1992.

4. Title modified.

Comments From the National Association of Securities Dealers

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

NASD®

November 27, 1992

National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1506
(202) 728-8000

Richard L. Fogel
Assistant Comptroller General
United States General
Accounting Office
General Government Division
820 First Street, N.E.
Suite 500
Washington, D.C. 20002

Dear Mr. Fogel:

We have reviewed the draft of your report entitled "PENNY STOCKS: Regulatory Actions to Reduce Potential for Fraud and Abuse." There are a few supplemental facts that we believe should be included in the report to more fully describe the NASD's regulatory and enforcement activities in the penny stock area.

For purposes of this letter, we are expressing our comments in the order of the captioned sections of the report. Our comments will be confined to the sections appearing in Chapters 1 and 2 of the report. In this regard, we will not separately repeat our comments with respect to the "Executive Summary," but would appreciate having them appropriately reflected in that section.

Our comments to Chapter 1 of the report follow.

Now on p. 16.
See comment 1.

INTRODUCTION (Page 13)

Footnote 1 to this section distinguishes the non-NASDAQ over-the-counter stock market where penny stocks are traded from our National Market System ("NMS") and NASDAQ Small Cap markets. However, we do not believe that the report provides enough information to clearly distinguish the significant and important differences between the NMS and NASDAQ Small Cap markets (the "NASDAQ Markets"), and the non-NASDAQ over-the-counter market. Therefore, we request that the vast distinctions between these markets be addressed early in the final report. Specifically, NASDAQ securities have stringent listing and maintenance standards. Further, the NMS and NASDAQ Small Cap markets are characterized by real-time trade reporting for these securities, and in this regard, the NASDAQ Markets test the validity of NMS and NASDAQ Small Cap securities' quotations against actual transactions reported on a real-time basis throughout the trading day. Testing is accomplished by our Market Surveillance Department through computerized surveillance systems at the NASD which continuously monitor the validity of each quote by comparing these real-time trade reports (made within 90 seconds of the execution) to the inside quotations that existed in the NASDAQ Markets at the time of the transaction. Other sophisticated computerized surveillance systems test NMS and NASDAQ Small Cap issues for integrity based on excess spreads, marking the close, and unusual price and volume swings based on unique parameters established for each security. In short, NMS and NASDAQ Small Cap trade reporting

Richard L. Fogel
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materially enhances the visibility and integrity of the NASDAQ markets by increasing transparency of information for investors and issuers, facilitating best execution, permitting immediate collection and scrutiny of trading information for regulatory purposes, and permitting the compilation of historical price and volume data for analysis, research and regulatory purposes.

By contrast, the non-NASDAQ, non-exchange over-the-counter markets consist primarily of securities appearing in the NASD's electronic Over-The-Counter Bulletin Board ("OTCBB") and in the National Quotation Bureau's ("NQB") "Pink Sheets". Presently, non-NASDAQ, non-exchange listed penny stocks do not "trade" through computers. Executions are accomplished by broker-dealers communicating with each other by telephone. The NASD did, however, initiate significant regulatory and technological advancements when, on September 1, 1988, it mandated specifically defined end of day price and volume reporting for principal transactions in non-NASDAQ over-the-counter securities. Thereafter, on June 1, 1990, the NASD launched its electronic OTCBB, which displays and dynamically updates quotations on a real-time basis in over 4,000 non-NASDAQ, non-exchange listed OTC issues. Moreover, as recognized in the report, the NASD intends to bring real-time trade reporting to the non-NASDAQ OTC marketplace in 1993.

Now on p. 18.

PENNY STOCKS HAVE BEEN USED TO DEFRAUD INVESTORS BUT ALSO INCLUDE LEGITIMATE OFFERINGS OF SMALL COMPANIES (Page 16)

Now on p. 18.

The final paragraph of this section (page 17) briefly addresses the NASD's electronic OTCBB and represents that non-NASDAQ securities have no listing requirements. The paragraph notes that "SEC rules require that issuers must generate and broker-dealers that act as market makers must review and maintain financial and other information on stocks and the issuers." The draft also points out that our Anti-Fraud Department analyzes the information to identify and require correction of deficiencies. We urge an expansion of this paragraph to cite SEC Rule 15c2-11 and Schedule H, Section 4, of the NASD's By-Laws. These important rules and regulations which focus explicitly on the non-NASDAQ market are part of a vigorous NASD regulatory program.

See comment 2.

Rule 15c2-11 identifies the current financial and other information that issuers must generate, and which must be obtained, reviewed, and maintained by broker-dealers seeking to initiate or resume quotation dissemination in a non-NASDAQ, non-exchange listed security. Schedule H, Section 4, requires broker-dealers to submit information gathered pursuant to Rule 15c2-11 to the NASD before initiating or resuming a quotation of a non-NASDAQ over-the-counter equity security in any quotation medium. In addition, Section 4 requires members to specify the basis and factors considered in establishing their initial priced entries for a non-NASDAQ security before such entry may be published in any quotation medium. The NASD critically analyzes the submitted material for either clearance or the identification of deficiencies. Until deficiencies are satisfactorily corrected, the subject quotation cannot properly be disseminated in any inter-dealer quotation medium and the usual result is the preclusion of trading activity and the consequent protection of the investing public. To the extent that broker-dealers have violated the provisions of Rule 15c2-11 or Schedule H, Section 4, disciplinary actions have been initiated. Furthermore, in an effort to emphasize the importance of Rule 15c2-11 and Schedule H, and to further educate the membership on these provisions, the NASD and SEC staffs have worked together to prepare a comprehensive Notice to Members that was circulated in October of 1992.

Richard L. Fogel
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Page 3

HOW PENNY STOCK FRAUD HAS BEEN COMMITTED (Page 17)

Now on p. 19.
See comment 3.

Markups and markdowns are briefly discussed in footnote 9 (page 18) of this section, and are also addressed in later sections of the report. We believe that our Notice to Members 92-16, which has been widely recognized as an important authoritative writing on markups and markdowns, should be referenced in and attached as an addendum to this report. Additionally, we suggest that consideration be given to more fully explaining that excessive markups have been a particular problem in the penny stock market and that through its examination and investigative functions the NASD has had significant success in detecting abusive situations, initiating enforcement actions, and imposing strong sanctions. Also noteworthy is the fact that the NASD has several Rules of Fair Practice, namely, Article III, Sections 1, 4, and 18, that are applicable to excessive pricing activity, and that Section 18, our anti-fraud provision, is regularly employed as an enforcement tool when markups are found to exceed 10% over the prevailing market price. Moreover, it is significant that since the inspection leading to the draft report was conducted, the SEC affirmed several very important NASD disciplinary actions involving markup/markdown violations, including Blinder Robinson (Exchange Act Release No. 31095, August 26, 1992); Dale Dwight Schwartzenhauer (Exchange Act Release No. 34-31086, August 25, 1992); F.B. Horner & Associates, Inc. (Exchange Act Release No. 34-30884, July 2, 1992); Century Capital Corp. of South Carolina (Exchange Act Release No. 34-31203, September 17, 1992); Osborne, Stern and Company, Inc. (Exchange Act Release No. 34-31211, September 22, 1992); and Lake Securities, Inc. (Exchange Act Release No. 34-31283, October 2, 1992). All of these cases are significant and cover a wide range of issues relating to markups and markdowns. However, special notice should be given to the Blinder Robinson decision as this hotly contested matter focuses on penny stocks and is likely to be viewed as the most significant markup case since 1984, when the Commission issued the leading markup decision of Alstead Dempsey & Co., Inc., 47 S.E.C. 1034 (1984).

Now on p. 20.

HISTORY OF PENNY STOCKS (Page 19)

See comment 4.

As of February 1992, the SEC had identified 186 active penny stock firms. The draft represents that as of June 1992, the SEC has identified 165 penny stock broker-dealers. This significant 21 firm decrease in only four months is not mentioned in the draft, and we believe that this information should be included as it strongly supports a conclusion that ongoing regulatory and enforcement efforts continue to have a significant effect in curtailing penny stock abuses.

See comment 5.

The final part of this section indicates that "law enforcement officials" believe that penny stock issuers have turned to stocks priced just above $5, to avoid the penny stock definition. Fraud has, historically, shown no boundaries, and creative miscreants have been able to perpetrate securities fraud by illegally or fraudulently offering and selling securities at various pricing levels through a multiplicity of means. There are certainly cases currently under review by the NASD that involve securities priced above $5, and we are closely monitoring the securities being sold by known penny stock dealers to make certain that any changes in product mix is immediately detected and pursued if questionable activity is taking place.

Richard L. Fogel
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Page 4

NEW LAW AND SEC RULES EXPAND PENNY STOCK REGULATION (Page 21)

See comment 6.

We suggest that this section describe the NASD's efforts in developing comprehensive approaches to examine for compliance with the new Penny Stock Reform Act Rules and Rule 15c2-6. In both instances, the NASD was the primary contributor along with the SEC for the initial preparation of examination modules designed to test broker-dealer compliance. Regarding Rule 15c2-6, the final module was used by NASD, SEC and state staff alike to effectuate the "cold call examination sweep" referenced in Chapter 2 of the report. Since that time, the module continues to be used by the NASD to examine for cold call rule compliance.

Shortly after the effectiveness of Rule 15c2-6, the NASD also prepared with the SEC a comprehensive Notice to Members in question and answer format. That Notice addressed the key features of Rule 15c2-6 and, we believe, significantly contributed to broker-dealer compliance.

Similarly, in mid-August 1992, the NASD staff submitted for SEC comment the initial draft of an extensive examination module designed to test broker-dealer compliance for all of the new Penny Stock Reform Act Rules. Thus, as with Rule 15c2-6, the NASD has been a central player in developing the module and will be pivotal in the training of NASD, SEC, and state examiners nationwide with respect to the new Penny Stock Reform Act Rules. In fact, we have scheduled three training programs for NASD, SEC and state examiners addressing the Penny Stock Reform Act Rules. Additionally, we have already distributed Notices to Members to educate our membership on the new rules and have recently provided members with a model disclosure document required by Rule 15g-2. That rule became effective July 15, 1992 and requires that broker-dealers provide customers with the disclosure document in connection with penny stock transactions, unless an express exception applies.

OBJECTIVES, SCOPE, AND METHODOLOGY (Page 23)

Now on pp. 25-26.

We believe that the discussion on pages 26 through 28 of this section is simply stating that the suitability and disclosure requirements of the various penny stock rules could be circumvented if unethical penny stock issuers were permitted to list their securities on exchanges or NASDAQ. If permitted to list on certain exchanges or NASDAQ, it is true that issuers could remove their securities from the definition of "penny stock". We are confident, however, that unethical issuers of penny stocks cannot simply choose to enter these markets because they would have to meet stringent listing and maintenance standards (which the NASD rigorously applies) as well as be subject to more intense regulation and surveillance. This is recognized on page 62 of the report.

Now on p. 52.

For clarity, we suggest that the GAO's report delete the last sentence of the continuing paragraph on page 28, as that sentence speaks to surveillance capabilities and does not relate to the immediately preceding discussion on the application of listing and maintenance standards. However, should you decide to leave this sentence in the report, it should be clearly noted that the NASDAQ Markets have surveillance capabilities at least as proficient as those in place at the exchanges.

See comment 7.

We now present our comments to Chapter 2 of the report.

Richard L. Fogel
November 27, 1992
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Now on p. 28.

NASD'S RESOURCES, PROCEDURES, AND TECHNIQUES FOR REGULATION OF THE PENNY STOCK MARKET (Page 29)

This first section of Chapter 2 introduces the toll-free number operated by the NASD and addresses branch office examinations of penny stock firms. In that improvement is recommended in these two areas, we have expressed our comments in the separate sections below that are dedicated to these subjects. We would appreciate having the highlights of our comments incorporated into this opening section as well.

Now on p. 29.

REAL-TIME TRADE REPORTING SHOULD IMPROVE SURVEILLANCE OF PENNY STOCK MARKET (Page 31)

Now on pp. 30-31.
See comment 8.

Pages 32 and 33 accurately capture the significant benefits that real-time trade reporting will bring to the non-NASDAQ over-the-counter marketplace. The report should be updated to reflect material developments in this area by explaining that the NASD Board of Governors recently authorized the NASD staff to submit the OTCBB service for designation as a Section 17B (of the Exchange Act) authorized service by making the necessary filings with the SEC to effectuate the requirements. Under Section 17B, the SEC is to oversee the development of an electronic market system for penny stocks with specified characteristics, such as the display of firm quotations for a minimum unit of trading and real time reporting. With the addition of real-time trade reporting to its already existing display of firm quotations, we are confident that the NASD's electronic OTCBB service will qualify for permanent Section 17B designation. Gaining this designation will, among other things, enhance the NASD's surveillance capabilities and facilitate member firms' compliance with the Penny Stock Reform Act Rules. In this regard, it is anticipated that last sale reporting by members of transactions in non-NASDAQ over-the-counter equities will mirror those in place for the NASDAQ Markets. In this regard, in File No. SR-NASD 92-48, the NASD has filed a proposal with the SEC to adopt real-time trade reporting rules.

Now on p. 31.

NEW 800-NUMBER SERVICE DOES NOT PROVIDE ARBITRATION INFORMATION (Page 33)

Now on p. 32.
See comment 8.

As a result of our efforts to make the toll-free number service even more beneficial to the public, we suggest that the report, at the top of page 35, disclose that the NASD is actively considering plans which could provide the public with the ability to obtain both disciplinary and final arbitration information through the same toll-free number. If done, we will have fully responded to your suggestion that the NASD provide public investors who request information on the NASD's toll-free phone service with information on final arbitration awards.

Now on p. 38.

NASD RARELY VISITED BRANCH OFFICES (Page 44)

The draft comments that the NASD rarely visited branch offices. The report cites that during 1988 through 1990, in a review of three district offices located in Atlanta, Denver and New York, only nine branch office examinations were conducted and all nine were done by the Atlanta

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District Office. The report identified a total of 197 branch offices of penny stock firms in the three locations and concluded that the NASD did not have standards for determining the frequency and number of branch offices that should be examined to adequately deter fraudulent and abusive practices in penny stock firms.

See comment 9.

Your reference to the nine exams of branch offices is simply inaccurate. We have reviewed the number of branch office examinations conducted at the three locations during the period 1988 through 1990 and our review discloses that a total of 61 branch offices were examined--4 in Denver, 49 in Atlanta and 8 in New York. The 61 examinations represents 30.2% of the 197 branch offices identified during the GAO inspection. We have compiled data to determine the start date and the completion date of all 61 branch office examinations conducted to evidence our branch examination program in connection with penny stock firms. Once these materials are reviewed by the GAO staff, we believe that the information will show that our branch office program in connection with penny stock firms was extensive and effective during the review period.

While we have no specific cycle established to conduct branch office examinations, each District annually establishes a program to conduct special branch office sales practice examinations. Some examples of the type of branches that are candidates for special examinations include offices that solicit sales of blind pools, engage in the sale of best efforts underwritings, make markets, have a large number of customer complaints or terminations for cause, or offices considered to be operating under a franchise agreement.

With respect to franchise branch offices, we established a program in 1990 to identify and conduct special franchise branch office examinations for all known penny stock firms. In District Staff Memorandum 90-38, we targeted specific penny stock firms and focused our examination to concentrate on: (1) the nature of other businesses operating out of the same office space of the branch office; (2) review of the registration status of all persons located at the branch as well as the registration status and/or business affiliation of persons controlling and/or having ownership in the franchise; and (3) concentration on the nature of supervision conducted by the firm's main office over the business conducted in the branch.

Now on p. 43.

COOPERATIVE ENFORCEMENT EFFORTS HAD POSITIVE RESULTS (Page 52)

As this section points out, the NASD has substantially cooperated in a variety of capacities with state and federal regulatory and law enforcement authorities. The only suggested area of improvement concerns the implementation of a formal referral process to federal authorities where there exists potential violations of criminal statutes.

See comment 10.

The report accurately details the NASD's view that the current procedure should be maintained. It is important, however, for the report to make clear that the NASD is a private organization and not an extension of the arm of any governmental agency. It should be emphasized in the report that maintaining this separation is essential to our enforcement program. The NASD has very important and critical regulatory authority in its Rules of Fair Practice which requires broker-dealer members and associated persons to provide documentary and oral

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information in connection with investigations. The invocation of constitutional privileges, such as the potential ability to withhold incriminating material, is not applicable in the context of an NASD inquiry as it would severely inhibit a self-regulatory organization from satisfactorily discharging its obligations. A formal referral system to criminal authorities could be an issue seized on by those who would like to place in jeopardy this critical examination and investigatory tool, something the NASD must safeguard against at all costs. Besides, the process is working very effectively in its current form.

Furthermore, as this report recognizes, senior NASD staff routinely assesses the seriousness of potential or proven violative conduct uncovered during our independent examinations and inquiries and whenever appropriate either makes referrals to, or agrees to work cooperatively with, other authorities. To the extent any law enforcement authority or regulator has a perception that potential cases may exist that are not being referred, we welcome them to contact the appropriate NASD district office or me. They are also encouraged to join in periodic coordination meetings where a variety of current issues, including investigations and disciplinary matters are addressed. Devoting the resources necessary to participate in these meetings would assuage any concerns that may exist that the NASD may not be referring, even inadvertently, all appropriate matters.

We are pleased to have been provided the opportunity to provide our comments. Overall, we find the report to represent a fair and balanced presentation of the NASD's regulatory and enforcement initiatives in the penny stock area. Quite frankly, we are gratified with what we have been able to achieve both on our own and in conjunction with state and federal regulatory and criminal agencies. Hopefully, our comments will be incorporated into the final report to ensure the most complete picture of our extensive efforts. We very much appreciate the opportunity to provide these comments, and are impressed with the professional manner in which the GAO staff has carried out its inspection. We remain available to provide any additional information that you may need.

Very truly yours,

John E. Pinto
Executive Vice President,
Compliance Division
National Association of
Securities Dealers, Inc.

cc: Joseph R. Hardiman
John T. Wall
William S. Clendenin
Frank J. Birgfeld
Marilyn B. Davis
William R. Schief
Daniel M. Sibears

The following are our comments on NASD's November 27, 1992, letter.

GAO Comments

1. Reference to this information added to footnote 1.

2. Reference to rules and NASD's comments added to text.

3. Reference to NASD guidance on markups and markdowns and related enforcement actions added to footnote 9.

4. NASD's views added to text.

5. Text modified, including reference to this information.

6. Reference to NASD's role in enforcing SEC Rule 15c2-6 and reference to this information added to text.

7. As NASD suggested, for clarity we deleted the sentence.

8. Information added to text to reflect the new developments.

9. NASD said that it identified a total of 61 branch offices that it examined during 1988 and 1990. We requested the files for these 61 examinations and were provided files for 44 examinations. Of the 44 cases, 43 pertained to NASD's Atlanta district, including 1 duplicate copy of another, 7 that were included in our earlier review of examinations, 6 that were completed in 1991 after our review period, 2 that were not examinations of identified penny stock broker-dealers, and 1 that was a termination for cause examination. Hence, 26 of the 43 Atlanta district branch offices examinations were of penny stock broker-dealers and field work was completed within our review period. The other file that NASD provided pertained to a visit that New York district examiners made to a branch office of a broker-dealer after receiving a tip from an employee of a different broker-dealer. After we had received NASD's official comments, NASD officials said that the 61 branch office examinations referred to in NASD's letter was not accurate because this figure included terminations for cause examinations and reviews of new registrants done at branch offices and other examinations not done during the time period of our review. The officials said that our revised count of a total of 36 branch office examinations was the correct amount. We modified the text as appropriate to reflect this new information.

10. Text modified and reference to this information added.

Major Contributors to This Report

General Government Division, Washington, D.C.

Larry D. Harrell, Assistant Director, Financial Institutions and Markets
David Tarosky, Evaluator-in-Charge
Darleen Wall, Evaluator
Gillian M. Martin, Evaluator
Susan Westin, Senior Economist
Carl Ramirez, Social Science Analyst
Katherine D. Kitzmiller, Secretary

Atlanta Regional Office

Veronica O. Mayhand, Evaluator
Sylvia L. Diaz, Evaluator

Denver Regional Office

Maria A. Durant, Evaluator

New York Regional Office

John P. Harrison, Senior Evaluator
Ray L. Gast, Evaluator

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