Making Capital Formation Work for Smaller Companies and Investors

Commissioner Luis A. Aguilar

Oct. 30, 2015

Small businesses are vital to our nation's economic growth and well-being.[1] In fact, our nation's small business owners create almost two out of every three new jobs and employ more than half of the U.S. workforce.[2] It is therefore important to provide opportunities for entrepreneurs and investors to come together and put capital to productive uses through the development of new ideas, products, and services that make America stronger and create new jobs that bring financial security.[3]

Ultimately, the success of small businesses depends on their ability to access capital.[4] To that end, because many small businesses are thought to have more difficulty than established businesses in getting traditional loans,[5] Congress has provided the Commission with authority to promulgate rules to facilitate access by small businesses to financing from the capital markets.[6]

In order for these rules to be successful, and, just as critically, sustainable, the Commission is tasked with creating an ecosystem for capital formation that works for small businesses and investors alike. Thus, the challenge is to develop a system that enables businesses to raise capital in a cost-effective way and, at the same time, provide ways to benefit and protect investors. After all, without investors, there can be no capital formation.

Crowdfunding and Rules 147, 504, and 505

Today, the Commission considers various rules to improve the capital formation process for small businesses. First, the Commission considers adopting new rules under Title III of the JOBS Act,[7] so that small businesses can raise capital from investors in crowdfunding transactions.[8] Second, the Commission proposes various amendments to Rules 147 and 504 to make them more efficient and usable. Lastly, the Commission is requesting comments on existing Rule 505 to assess how it is being used and whether it will still be needed if the proposed amendments are adopted.[9]

I will first discuss Regulation Crowdfunding. This Regulation is designed to help startups and small businesses raise capital by providing an exemption from federal registration that will allow internet-based securities offerings of up to $1 million from investors over a 12-month period. To address the inherent risks associated with investments in startups and smaller businesses generally, and the uniqueness of creating a regulatory regime designed for internet-based offerings, today's rules also include various investor protections. These include, among others, mandated disclosures and limits on what investors can put at risk (based on their income and net worth).

Importantly, Regulation Crowdfunding also provides a framework to govern how Crowdfunding intermediaries—such as a registered broker-dealer or a funding portal—can conduct securities offerings. Because these intermediaries essentially act as "gatekeepers" for these offerings, this framework should provide additional investor protection. Moreover, since these gatekeepers are indispensable for making Crowdfunding viable, it is critical for the registration regime for funding portals to be ready as soon as today's Crowdfunding rules go into effect. It is my understanding that FINRA has already filed its proposed rule changes for funding portals, including the registration rules,[10] and is waiting for Commission action. Accordingly, I urge the Commission and its staff to expedite the review of FINRA's application.

In addition to adopting Regulation Crowdfunding, the Commission is also proposing amendments to Rule 147 under the Securities Act and Rule 504 of Regulation D, as well as requesting comments on Rule 505 of Regulation D.

Rule 147 has not been updated since it was first promulgated in 1974, and it is past time to consider how to revise the rule to reflect the reality of technological developments and the modern business environment.[11] To that end, the proposed amendments provide additional flexibility for small businesses to raise capital while establishing appropriate safeguards for the purchasers of these securities.

In addition, the Commission is proposing to increase the offering limit under Rule 504 from $1 million in a 12-month period to $5 million in the same period, and is requesting comments on whether the Rule 505 exemption remains necessary in light of the amendments being proposed to Rule 504. Based on an analysis conducted by the staff of our Division of Economic and Risk Analysis ("DERA"), the use of the Rules 504 and 505 exemptions have been declining over time, and now constitute only a very small percentage of overall offerings based on the Regulation D exemptive regime.[12] The hope is that today's proposal will reinvigorate Rule 504. In the end, the total sum of the questions asked in today's releases as to Rules 504 and 505 is whether the changes being proposed will breathe new life into Rule 504 in a way that will work for both issuers and investors, and, if so, whether Rule 505 will still have utility.

Three Essential Components of Capital Formation

In my view, there are three essential components to facilitating true capital formation by small businesses through securities offerings: first, an efficient and useful marketplace for small offerings; second, a vibrant secondary market for these securities; and third, an appropriate back-office infrastructure that facilitates this secondary market. These three components cover the issuance, trading, and clearance and settlement of trades in the securities of smaller issuers.

Integrity in the Marketplace for Small Offerings

The foundation of our capital markets rests on the notion that those who are interested in acquiring capital and those who are interested in providing it can meet in a marketplace where the exchange of capital takes place.[13] Facilitating true capital formation is about ensuring that companies with the best ideas—even if those ideas are risky—can get the financing needed to make those ideas a reality. However, it is equally critical to a successful capital formation environment that investors are provided appropriate protections.

Today's Crowdfunding rules and the proposed amendments to Rules 147 and 504 reflect the Commission's ongoing efforts to create more available options for small businesses to access the capital markets. Previously, the Commission has adopted Congressionally-mandated amendments to existing exemptive regimes under both Regulation A (also known as "Regulation A-plus") and Regulation D.[14]

A reality of these new Commission rules, and various other provisions statutorily required by the JOBS Act, is that in combination they will result in companies having many more shareholders without the need to register under the federal securities laws as publicly-traded companies.[15]

In essence, companies will be able to sell their securities to a wider swath of the public and remain outside of the registration and disclosure provisions of the Exchange Act for longer periods of time. This reality raises a host of potential problems. In particular, unlike larger, more well-established publicly-owned companies that receive market attention as a result of their public disclosures, these smaller issuers will face a lack of an active secondary market for their securities.[16] Obviously, this has been a long-standing problem for smaller companies, but, in light of these new developments, it is clear that the problem is only going to get worse.

A Strong Secondary Market for Small Issuers

There is no question that for a capital market to thrive it needs a vibrant secondary market, where previously issued securities can be bought and sold.[17] It is important to consider the need for such a secondary market in the context of adopting and proposing rules to facilitate exemptive transactions because, under the new or recently-amended exemptive regimes, the vast majority of these widely-offered securities become freely-tradable immediately upon issuance or after a short holding period.[18] These exemptive regimes include Crowdfunding,[19] Regulation A, Rule 506 of Regulation D, and the proposed versions of Rules 147 and 504.

Accordingly, another reality of the combined impact of these exemptive rules is that they will result in a very large number of shareholders needing to find liquidity in the secondary markets. And another reality is that these securities will undoubtedly be purchased by investors that face a secondary market that is less fair, less liquid, and less transparent than the secondary market for listed securities.[20]

The coming tsunami of unregistered and unlisted shares[21] requires new solutions for an active secondary market to take hold, and I am going to mention two ideas—ideas that I have previously discussed at greater length in other settings.[22]

First, the Commission should examine whether the challenges that have thwarted prior efforts to develop venture exchanges can be overcome in ways that benefit investors. Yet the Commission cannot stop there, for there may well be other, potentially better paths to a robust secondary market for these securities. Some avenues worth exploring include determining whether exchanges could develop new listing tiers for these securities,[23] or whether these securities could trade on alternative trading systems.[24] These potential solutions may implicate especially thorny regulatory issues, but I am confident they could be overcome.

Second, the Commission should reform Exchange Act Rule 15c2-11, with a specific focus on the rule's so-called "piggy-back" exception.[25] Rule 15c2-11 is widely used by broker-dealers to trade in unlisted securities, such as those that will likely result from sales under today's

Crowdfunding rules. Under the rule's "piggy-back" exception, broker-dealers are permitted to publish quotations for a security without complying with the rule's due diligence and information requirements if any other broker-dealer has published regular and frequent quotations for that security.[26] Accordingly, a broker-dealer can "piggy-back" on either its own or another broker-dealer's prior quotations. The existing problems with this current rule are well-known, and they boil down to an opaque and loosely overseen trading regime that too often wholly fails investors.[27]

As I've said in a prior speech, possible solutions to the Rule 15c2-11 problem include: (1) eliminating or amending the broker-dealer "piggy-back" exception for small business securities; (2) requiring broker-dealers that publish quotations to obtain and review *current* information about an issuer *at least annually*; and (3) enhancing investor access to the information collected, reviewed, and maintained by the broker-dealer about the issuer.[28] While the need to fix Rule 15c2-11 has been well known, and while the staff has thrice proposed changes to Rule 15c2-11, no action has been taken to fix the rule.[29]

Accordingly, at my request, the staff has included a discussion in the Crowdfunding release about Rule 15c2-11. In brief, it states that the staff is directed to evaluate promptly Rule 15c2-11 in light of the rule's historical application and recent market developments—such as today's Regulation Crowdfunding, Regulation A-plus, etc.—to assess how the rule is meeting regulatory objectives and to determine whether any changes are necessary. Separately, as part of a broader review of Regulation Crowdfunding that the staff plans to undertake within three years of the effective date of these rules, the staff will also assess the development of the secondary market trading in Crowdfunding securities and will report to the Commission whether further actions are necessary with respect to Rule 15c2-11.[30] Finally, I urge the staff to intensify its efforts to police compliance with Rule 15c2-11. Prior efforts to enforce this important rule have fallen short. I urge the Office of Compliance Inspections and Examinations to build upon its recent sweep of a limited number of broker-dealers for Rule 15c2-11 compliance, and to prioritize Rule 15c2-11 in its risk-based exam selection process going forward.

It is critical that a viable secondary trading environment exists for unregistered and unlisted securities of small businesses, and one that promotes a fair and transparent market for these securities. Such an approach is necessary to protect investors and promote the growth and success of small businesses.

A Robust Clearance and Settlement Infrastructure for Small Issuers

Finally, a secondary trading market for unregistered and unlisted securities of small businesses cannot thrive unless there is a workable system for the clearance and settlement of trades that permits the efficient transfer of securities ownership.[31] In today's large and complex securities markets, however, much of these back-office responsibilities have shifted to central securities depositories ("CSDs")—the world's largest of which is the Depository Trust Company ("DTC")—which were developed to allow for the efficient transfer of securities ownership between buyers and sellers.[32] Today, central securities depositories provide critical custody and recordkeeping services using an electronic "book-entry" system. This system permits the efficient electronic transfer of an issuer's securities rather than the exchange of actual paper stock certificates. Such an electronic trading infrastructure is critical for an active and functioning secondary market for securities.

For most issuers, however, access to this electronic "book entry" system first requires that the securities be deemed eligible for DTC services, meaning that the securities satisfy certain criteria established by DTC.[33] I am concerned that, as the Commission provides new fundraising options for smaller issuers, an unintended consequence may be to enable an avalanche of small issuer securities to enter the capital markets without having access to DTC's electronic "book entry" system—because they will fail to meet DTC's criteria or for other reasons.[34]

Many market participants simply see the burden of dealing with physical stock certificates as impractical and/or costly,[35] and, as a result, may charge additional fees to handle these transactions.[36] In fact, trading in paper certificates is nearly non-existent, and, in recent years, accounted for just one-tenth of one percent of daily trading volume.[37] Yet, this small marketplace niche of paper certificate trading is widely believed to be dominated by retail investors, and is thus vital to the capital formation process of smaller companies.[38] Accordingly, the Commission should explore ways to work with DTC or otherwise facilitate or incentivize the development of an alternative electronic "book entry" system that can be made available to smaller issuers and their investors.

The success of the Commission's efforts to facilitate capital formation for smaller businesses will be substantially impacted by the lack of an efficient and reliable way for investors in smaller businesses to transfer their shares. I am hopeful that 21st Century technology can bring a cost-effective solution to this problem.

To this end, I recently had a discussion with a very senior officer at The Depository Trust & Clearing Corporation ("DTCC")—the parent company of DTC—who agreed to look into this issue and to determine what DTCC can do to help perform these back-office functions for smaller issuers.[39]

I urge the staff of the Division of Corporation Finance and the Division of Trading and Markets to follow-up on this issue. And to do so with urgency and speed.

Let's Stop Delaying and Fix the Problem

Before becoming a Commissioner, I spent much of my professional career as a practitioner involved in capital formation through public and private offerings. I worked with companies—big and small—that grew their businesses by making better, smarter, and more innovative products, and selling more of them. It has been my experience, in both the private and public sectors, that effective common sense regulation—and one that offers investor protection—is necessary to foster a viable environment for true capital formation. It has also been my experience that the sooner you address and resolve known problems, the more likely you can prevent them from becoming unmanageable and destructive catastrophes. The continuing and well-known difficulty of trading small issuer securities is such a problem that requires our immediate attention.

Conclusion

In closing, today's rules reflect a well-thought out approach to capital formation that takes into account the need to protect investors. For these reasons, I will support both the adopting release for Crowdfunding and the accompanying proposing release and request for comments.

I would like to thank the staff from the Division of Corporation Finance, the Division of Trading and Markets, the Division of Economic Research and Analysis, and the Office of the General Counsel for their work on this rulemaking. I appreciate your dedication and the important work that you do to protect investors.

Thank you.

[1] For purposes, of these remarks, small businesses are defined as those independent businesses with fewer than 500 employees. Between 1993 and mid-2013, such small firms were responsible for 63% of net new jobs created, or more than 14 million of the nearly 23 million net new jobs created during this period. *See* U.S. Small Business Administration Office of Advocacy, *Frequently Asked Questions*, *available at* http://www.sba.gov/sites/default/files/advocacy/FAQ_March_2014_0.pdf.

[2] U.S. Small Business Administration, *Strategic Plan: Fiscal Years 2014-2018*, at 4, *available at* https://www.sba.gov/sites/default/files/aboutsbaarticle/SBA_FY2014-2018_Strategic_Plan_final_update.pdf (last visited Oct. 29, 2015).

[3] In order to facilitate the development of startups, emerging companies, and entrepreneurship, over the years the Commission has promulgated a number of regulations aimed at allowing small businesses to sell securities without having to comply with the full registration requirements of the Securities Act. *See*, for example, Rules 504 and 505 of the Securities Act of 1933 (the "Securities Act"). Consistent with the Commission's mission, these regulations always also consider appropriate investor protections.

[4] U.S. Small Business Administration, *Strategic Plan: Fiscal Years 2014-2018*, at 5, *available at* https://www.sba.gov/sites/default/files/aboutsbaarticle/SBA_FY2014-2018_Strategic_Plan_final_update.pdf (last visited Oct. 29, 2015).

[5] *See* Robert J. Dilger, *Small Business: Access to Capital and Job Creation*, Congressional Research Service (Feb. 18, 2014), *available at* https://www.fas.org/sgp/crs/misc/R40985.pdf (quoting an economist as saying, among other financing challenges that small firms face, that "[g]rowing firms need resources, but many small firms may have a hard time obtaining loans because they are young and have little credit history."). *See also* National Small Business Association, *Small Business Access to Capital Survey* (2012), *available at* http://www.nsba.biz/wp-content/uploads/2012/07/Access-to-Capital-Survey.pdf (noting that the National Small Business Association found in a 2012 study that 43% of small business owners surveyed could not get the financing they needed.)

[6] *See, e.g.,* Louis Loss, Joel Seligman, and Troy Paredes, *Fundamentals of Securities Regulation*, Vol. 1 (2011), at 529 (noting that Congress "has addressed the problem of financing small business" in various ways, including increasing the scope of the Commission's exemptive power under Securities Act Section 3(b), which provides the statutory authority for Regulation A.).

[7] The Jumpstart Our Business Startups Act of 2012 ("JOBS Act").

[8] *See Crowdfunding*, Release No. 34-_____ (Oct. , 2015), *available at* _____ ("Adopting Release").

[9] *See Proposed Rule Amendments to Facilitate Intrastate and Regional Securities Offerings*, Release No. 34-_____ (Oct. , 2015), *available at* _____ ("Proposing Release").

[10] *See Notice of Filing of a Proposed Rule Change to Adopt the Funding Portal Rules and Related Forms and FINRA Rule 4518*, Release No. 34-76239, SR-FINRA-2015-040 (Oct. 22, 2015), *available at* http://www.sec.gov/rules/sro/finra/2015/34-76239.pdf.

[11] *See* Recommendations of the Advisory Committee on Small and Emerging Companies (Sept. 23, 2015), *available at* https://www.sec.gov/info/smallbus/acsec/acsec-recommendation-modernize-rule-147.pdf (noting that the current use of Rule 147 has been made more difficult because certain of its conditions are inconsistent with modern business practices, such as the requirement that a business be organized or incorporated in-state.)

[12] *See* Proposing Release at V.A.1.a. (For example, DERA's (Division of Economic and Risk Analysis) analysis notes that "[c]ompared to the early 1990s when Rule 504 offerings constituted approximately 28% of all new Regulation D offerings, the proportion of Rule 504 offerings between 2009 and 2014 ranged between 3% and 4% of all new Regulation D offerings," while the data for Rule 505 offerings is even less than the Rule 504 offerings during the same period.).

[13] *See* Virginia B. Morris and Stuart Z. Goldstein, *Life Cycle of a Security*, p. 2, (2010).

[14] *See Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A)*, Release No. 33-9741 (Mar. 25, 2015), *available at* http://www.sec.gov/rules/final/2015/33-9741.pdf; *Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Release No. 33-9415 (July 10, 2013), *available at* http://www.sec.gov/rules/final/2013/33-9415.pdf.

[15] For example, Regulation Crowdfunding will conditionally exclude any purchaser of the shares from being counted as a record holder for purposes of Section 12(g)—and any future secondary purchasers of those shares would also be excluded under the same conditions. *See* Adopting Release (the Commission's rules under Crowdfunding would conditionally exempt securities sold under those provisions from the registration requirements of Exchange Act Section 12(g), provided that the issuer is current in its ongoing annual reports, has total assets not in excess of $25 million, and has engaged a registered transfer agent, and this exemption runs permanently with the securities). The JOBS Act requires that the Commission promulgate rules that, conditionally or unconditionally, exclude securities sold under the Crowdfunding provision from section 12(g) of the Exchange Act. *See* JOBS Act Section 303. Moreover, under the Commission's recently proposed rules to amend Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act"), as required by the JOBS Act, the number of record holders *any company* may have before it is required to publish annual and quarterly reports would greatly increase. *See Changes to Exchange Act Registration Requirements to Implement Title V and Title VI of the JOBS Act*, Release No. 33-9693 (Dec. 18, 2014), *available at* http://www.sec.gov/rules/proposed/2014/33-9693.pdf. Currently, companies with more than 500 shareholders of record are required to be registered with the SEC under Exchange Act Section 12(g), while these proposed rules would expand that trigger to 2,000 record holders (or 500 holders who are not accredited investors). In addition, these proposed rules would exclude from the count of record holders those who acquired the securities pursuant to an

employee compensation plan. As a result, a company could have an enormous number of record holders without being required to provide the same level of disclosures as those applicable to public companies. The concern is that without the disclosure routinely provided by public companies, smaller business shares that are carved out from the Section 12(g) registration requirements would be harder to value because of this lesser transparency.

[16] *See, e.g.,* Comment letter from John Perkins, Chairman, Small Business Capital Access Association (April 22, 1997), *available at https://www.sec.gov/rules/other/s71597/perkins1.txt* ("As the SBCAA stated last year, the biggest problem faced by small companies trying to raise capital is the lack of a secondary market for the investors who invest in these offerings.").

[17] *See* Virginia B. Morris and Stuart Z. Goldstein, *Life Cycle of a Security*, p. 2, (2010).

[18] For example, today's Crowdfunding rules provide for a one-year holding period unless the Crowdfunding securities are sold to the issuer, an accredited investor, as part of a registered offering, or to a member of the purchaser's family or the equivalent, to the purchaser's trust (or a family trust), or in connection with the death or divorce of the purchaser. *See* Adopting Release at Rule 227.501 (restrictions on resales). In addition, today's proposed amendments to Rule 147 provide that purchasers can immediately resale Rule 147 securities to residents within the purchaser's state or territory, but are restricted from reselling such securities to residents outside the state or territory for a period of 9 months. *See* Proposing Release at Rule 230.147(e).

[19] *See* Securities Act §3(b)(2)(C), as added by JOBS Act §401(a), and Securities Act §4(a)(6), as added by JOBS Act §302(e), and Securities Act Rule 506(c), as added by JOBS Act §201. Under today's proposed Rule 147, the securities could be immediately resold to in-state residents, but would be subject to a 9-month resale restriction for sale to out-of-state residents. *See* Rule 230.147(e) of Proposing Release. Securities Act Rule 144 allows public resale of restricted and controlled securities if a number of conditions are met, including, for example, meeting the holding period requirement of one year (assuming the seller is not an affiliate of the issuer). *See* Rule 144 under the Securities Act.

[20] A "listed" security is one that has been accepted for trading by one of the organized and registered securities exchanges in the United States, such as NASDAQ or the New York Stock Exchange. *See* Nasdaq Glossary, *available at* http://www.nasdaq.com/investing/glossary/l/listed-security.

[21] Kay Koplovitz, *One Year After Title II And Equity Crowdfunding*, Huffington Post (Oct. 10, 2014), *available at* http://www.huffingtonpost.com/kay-koplovitz/one-year-after-title-ii-a_b_5965466.html (noting that "Title III may cause a funding tsunami to hit the market.").

[22] *See, e.g.,* Commissioner Luis A. Aguilar, *The Need for Greater Secondary Market Liquidity for Small Businesses* (Mar. 4, 2015), *available at* http://www.sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html.

[23] *See id.;* Testimony of Nelson Griggs, Executive Vice President, Nasdaq, Before the Senate Subcommittee on Securities, Insurance and Investments (Mar. 10, 2015), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=eeb822ac-fba1-448d-a57e-5a1a6941d4e8. *See also* Commissioner Daniel M. Gallagher, *Whatever Happened to Promoting Small Business Capital*

Formation? (Sept. 17, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542976550; and Sarah N. Lynch, *SEC mulls promoting creation of U.S. venture exchanges—White*, Reuters (Feb. 20, 2015), *available at* http://www.reuters.com/article/2015/02/20/sec-exchanges-idUSL1N0VU1VU20150220.

[24] I am aware that some alternative trading systems currently offer the ability to trade certain unregistered securities. *See, e.g.,* Ari Levy, *How Nasdaq is catering to tech start-ups*, CNBC (Oct. 23, 2015), *available at* http://www.cnbc.com/2015/10/23/how-nasdaq-is-catering-to-tech-start-ups.html. Nevertheless, my counsel spoke with the Commission's staff in the Division of Trading and Markets and was informed that certain regulatory issues likely would have to be addressed before these existing platforms could have the ability to trade the securities that are the subject of the exemptive regimes discussed in these remarks, including Crowdfunding, Regulation A, Rule 506 of Regulation D, and the proposed versions of Rules 147 and 504.

[25] In order to use Rule 15c2-11, broker-dealers who wish to publish a quote of unlisted securities, which will often be smaller issuers, are required to review and maintain certain information about the security and the issuer. In addition, Rule 15c2-11 requires broker-dealers, prior to publishing quotes of these unlisted securities, to have a reasonable basis for believing that this information is accurate in all material respects and that it was obtained from reliable sources. *See* Exchange Act Rule 15c2-11, 17 CFR 240.15c2-11. In this way, Rule 15c2-11 is about trust. Specifically, investors need to have confidence that the quotes for these securities are fair and accurate. Without this confidence, a fair and liquid secondary market for these securities will not exist.

[26] FINRA implements Exchange Act Rule 15c2-11 through its Rule 6432, which prohibits a member from initiating or resuming the quotation of certain "non-exchange listed securities" in a quotation medium unless the member has demonstrated compliance with the requirements of Exchange Act Rule 15c2-11 pertaining to the review and maintenance of information about the security and the issuer. For these purposes, FINRA defines "non-exchange-listed security" as any equity security, other than a restricted equity security, that is not traded on any national securities exchange. To demonstrate compliance with FINRA Rule 6432 and Exchange Act Rule 15c2-11, a member must file with FINRA a Form 211, together with the information required under Exchange Act Rule 15c2-11(a), at least three business days before the quotation is published or displayed. Once a broker-dealer has filed a Form 211 with respect to a security, and that Form 211 is cleared by FINRA, the security may become "piggy-back" eligible, provided the quoting activity meets the requirements of Exchange Act Rule 15c2-11(f)(3). Exchange Act Rule 15c2-11(f)(3) sets forth frequency-of-quotation requirements which, if met, allow broker-dealers to publish quotations in the security without maintaining the information required by Exchange Act Rule 15c2-11 or filing a new Form 211.

[27] The problems of Rule 15c2-11 have long been recognized. In fact, in 1991, and then again in 1998, and in 1999, the Commission proposed comprehensive amendments to Rule 15c2-11 to address concerns about fraud and manipulation that had become increasingly common in microcap securities traded in the OTC market. *See Publication or Submission of Quotations Without Specified Information*, Release No. 34-39670 (Feb. 17, 1998), *available at* http://www.sec.gov/rules/proposed/34-39670.txt.

Over the past few years, the Division of Enforcement has brought hundreds of trading suspension cases as part of its Operation Shell-Expel to suspend trading in dormant shell companies that could be used for fraud in "pump-and-dump" schemes. Indeed, in fiscal year 2015 alone, the Commission suspended the trading in more than 330 issuers, which effectively prevents the misuse of the "piggy-back" exception under Rule 15c2-11, and revoked the registration of 132 dormant shell companies that were delinquent in their mandatory public filings for the same reasons. These trading suspension cases prevent broker-dealers from misusing the "piggy-back" exception, for example, by quoting the companies' securities when there is little-to-no current information available about the companies without conducting the proper due diligence. *See* SEC Press Release, *SEC Announces Enforcement Results For FY 2015* (Oct. 22, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-245.html; *see also* SEC Website, *Delinquent Filings Program* (Oct. 25, 2005), *available at* https://www.sec.gov/divisions/enforce/delinquent.htm; SEC Website, *Releases Related to Delinquent Filings*, *available at* https://www.sec.gov/divisions/enforce/delinquent/delingindex.htm. Although these actions were not brought for violations of Rule 15c2-11, trading suspensions and revocation proceedings are prophylactic measures designed to, among other things, force broker-dealers to conduct due diligence before they can provide price quotes for the suspended or revoked securities. Trading suspensions effectively eliminate the "piggy-back" exception because it is impossible for broker-dealers to comply with Rule 15c2-11 and publish quotations on the stock of companies that were the subject of trading suspensions. *See* SEC Website, Fast Answers, *Defunct Company, Stock Continues to Trade* (Jan. 15, 2013), *available at* http://www.sec.gov/answers/dfnctco.htm. In most cases, these companies are unable to provide current information, *e.g.*, because they are defunct or out of business. Similarly, when the Commission revokes the registration of stocks under Section 12(j) of the Exchange Act, broker-dealers are prohibited from executing *any* trades in these stocks. *See id.*

[28] *See* Commissioner Luis A. Aguilar, *The Need for Greater Secondary Market Liquidity for Small Businesses* (Mar. 4, 2015), *available at* http://www.sec.gov/news/statement/need-for-greater-secondary-market-liquidity-for-small-businesses.html#_edn32.

[29] In addition to the 1998 proposed amendments and 1999 re-proposed amendments to Rule 15c2-11, the Commission proposed revisions to Rule 15c2-11 back in 1991. *See Publication or Submission of Quotations Without Specified Information*, Release No. 34-39670 (Feb. 17, 1998), *available at* http://www.sec.gov/rules/proposed/34-39670.txt (discussing 1991 proposed amendments).

[30] Adopting Release at II.E.7.

[31] For most of its history, the securities markets operated by relying upon brokers to handle trade orders and to receive payment in exchange for securities, and relying upon issuers to handle the delivery, re-registration, and re-issue of individual physical stock certificates with every trade. *See* Virginia B. Morris and Stuart Z. Goldstein, *Life Cycle of a Security* (2010). *See id.*

[32] *See* Virginia B. Morris and Stuart Z. Goldstein, *Life Cycle of a Security* (2010). CSDs, like the DTC, permit issuers and their intermediaries to deposit the physical share certificates with the CSDs, who secure the certificates (or "immobilize" them) in a single location.

[33] *See* Securities Transfer Association Website, *available at* http://www.stctransfer.com/DTCInfo.html (noting that DTC eligibility is granted on a "case-by-case basis" and enumerating a list of possible reasons for a denial of DTC eligibility).

[34] If an issuer's shares are not DTC eligible, and cannot be transferred between brokerage accounts electronically, its shares cannot be traded easily. *See* Securities Transfer Association Website, *available at* http://www.stctransfer.com/DTCInfo.html. Indeed, whether or not an issuer's securities are "DTC eligible" may determine whether there may be a market for an issuer's securities at all.

[35] *See, e.g.,* Scottrade Website, *Stock Ownership*, *available at* https://research.scottrade.com/knowledgecenter/Public/education/Article?docId=938b3123c9ed421bb6a6252a471a4515 ("Because approximately three billion shares are traded every day, paper certificates have become impractical.")

[36] *See, e.g.,* Tradestation Website, *available at* http://www.tradestation.com/site-wide-items/disclaimers/legal/disclosures/otcbb-disclosure (last visited on Oct. 23, 2015) (noting that "[f]or various reasons, certain low-priced securities are not DTC-eligible or have had their eligibility revoked. As a result, the settlement of these physical positions can carry significant pass-through charges including execution fees, DTC fees, deposit fees, New York window fees, and transfer agent fees. These fees, which can vary and may be substantial, increase the cost of clearing and execution. Customers who trade non-DTC eligible securities are responsible for these charges, which can be as high as 10 times the value of the trade."); Alpine Securities Stock Brokerage & Investment Company, *available at* http://www.alpine-securities.com/Portals/0/Forms/Non-DTC%20Eligible%20Policy.pdf (noting that "[d]ue to their labor-intensive and high-risk nature" this broker-dealer has a "unique policy for non-DTC eligible securities," that includes additional fees and expenses for transactions in such securities.); Firstrade Website, *available at* https://www.firstrade.com/content/en-us/customerservice/faqs/illiquidfees/ (noting that "[c]ertain low-priced securities are not DTC-eligible or have had their eligibility revoked. As a result, the settlement of these physical positions can carry significant pass-through charges for our clearing firm, Apex Clearing Corp, including execution fees, DTC fees, deposit fees, New York window fees, and transfer agent fees. These fees, which can vary and may be substantial, increase the cost that Apex Clearing Corp, passes through for clearing and execution.").

[37] *See id.* Moreover, physical certificates may be lost, damaged, or stolen, which can make it more difficult for investors to trade such shares.

[38] *See* Scott McCleskey, *Achieving Market Integration: Best Execution, Fragmentation and the Free Flow of Capital* (2004), at 21 (noting that of those shareholders who still hold shares in paper form, they are primarily retail investors).

[39] I met personally with a Managing Director of DTCC on October 14, 2015, and had a follow-up telephone conversation with him on October 26, 2015.

Modified: Oct. 30, 2015