The Detriment of Rule 15c2-11's Application to Fixed Income Markets

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The Consequences of Unilateral Rulemaking Without Public Comment

SIFMA is concerned that the recent application of Exchange Act Rule 15c2-11 to fixed income markets will have significant, deleterious effects on fixed income market issuance, liquidity, and transparency. This interpretation – one inconsistent with long-standing precedent and issued without any opportunity for public comment – comes at the detriment of investors, issuers who depend on capital raised in fixed-income markets, and broker-dealers.

In Part I of this two-part blog series, we provide a history of Rule 15c2-11, often referred to as the Penny Stock Quote Rule, and its intent. In Part II, we discuss how this new interpretation could upend the trillion-dollar Rule 144A markets.

A rule to protect retail investors in equity markets

According to the U.S. Securities and Exchange Commission, its Rule 15c2-11: "governs the publication or submission of quotations by broker-dealers in a quotation medium other than a national securities exchange. Before a broker-dealer may initiate or resume quotations for a security in a quotation medium, the broker-dealer must review key, basic information about the issuer of the security. The Rule allows any qualified interdealer quotation system ("qualified IDQS") to conduct the required information review as well."

Since its inception in 1971, Rule 15c2-11 has targeted fraud in OTC equity markets, where the primary securities owners are retail investors. Investor protection is of utmost importance, and we support the SEC's efforts to enable investors to make better investment decisions and reduce fraud.

We note, importantly, that Rule 15c2-11 – long referred to as the SEC's penny stock quote rule – has never been applied to fixed income markets. While the Rule has referred to "securities" since its inception, it has only been applied to equity securities and we have been unable to find any history of its enforcement in fixed income markets.

The 2020 amendments to the rule illustrate the SEC's focus on OTC equity markets

In 2020, amendments were made to modernize Rule 15c2-11 and recognize advances in communications technologies since the last substantive amendments to the Rule thirty years before. Among other things, the amendments added public availability requirements for issuer information. "The amended rule represents another important step in our tireless and proactive efforts to protect retail investors from being victimized by microcap fraud," said Stephanie Avakian, Director of the Division of Enforcement.[1]

As demonstrated by the SEC's own statements and discussion in the proposed and final amendments, the SEC viewed the Rule as applicable to OTC equity markets. The amendments relied solely on OTC equity-markets data sources and showed no analysis of fixed-income markets. Indeed, they made generalizations in the related rulemaking releases that are not applicable to fixed income trading and markets (e.g., that microcap fraud occurs, or that the investor base is predominantly retail).

The Rule has never been applied to or enforced in fixed income securities markets and was not developed with fixed income market structure in mind. The Rule does not contemplate the differences in how liquidity is provided in fixed income markets vs. equity markets.

A new and surprising interpretation…

So, it came as quite a surprise when SEC staff in September 2021 stated that the Rule does, and has always, applied to fixed income markets – without any formal rulemaking process and without an opportunity for public comment, and without making any adjustments to the actual Rule. This interpretation not only surprised the investment industry, but appears to have surprised even SEC Commissioners:

“The application to the fixed income market was, frankly, not something that we had thought about as a Commission,” said SEC Commissioner Hester Peirce at SIFMA’s C&L Annual Seminar in March, “and so I found it disingenuous…We should be doing this through a rulemaking where there is input, where people are collectively thinking about these problems and doing so in a public way.” These remarks reinforce previous statements on the matter.[2]

Commissioners Peirce and Elad Roisman also issued a joint statement raising concerns that the SEC’s Fall 2021 Public Rulemaking Agenda does not include plans to “prevent Rule 15c2-11 from being misapplied to fixed-income securities” and that a full Commission rulemaking on the topic would “make a lot more sense than trying to shoehorn these securities into a rule designed for equity securities.”

…that rewrites the rules for fixed income markets without any notice or public comment

Then in December 2021, the SEC staff published a No-Action letter[3] that affirmed its new interpretation and also established a new and complex regulatory regime for Rule 15c2-11 as applied to fixed-income markets that provides some limited exceptions from the application of the Rule if certain conditions are met.[4]

While the SEC staff argues that technically the Rule has always applied, their actions (or lack thereof) belie the truth, which is that no one viewed the rule to scope in fixed income markets. This No-Action letter represents rulemaking by unilateral staff pronouncement, applying new rules to a market with extraordinarily short notice, rather than through the typical agency processes for developing new regulations through public and deliberative proceedings via Commission (not staff) rulemaking.

The consequences for issuers and investors

We believe application of the Rule to fixed income will increase costs, decrease liquidity, and risks reversing the gains in transparency that the fixed income markets have achieved from recent modernization and electronic quoting and trading.

For example, one impact may be a reduction of the availability of quotes for some fixed-income products, such as securities not clearly exempt from rule, returning those markets to more bilateral interaction for certain securities. For some products, there is no clear short- or long-term solution and we expect there could be a dramatic decrease in dealer activity that could be construed as a quotation, which would make price transparency needed by investors in fixed income securities less available.

Fixed income products are generally not exchange traded, vastly outnumber equities, and there is an important market for unregistered fixed income securities. Even where information is publicly available, such as for registered transactions or for publicly traded issuers, there is no existing compliance infrastructure for broker-dealers to rely on.

We continue to encounter market participants, particularly on the buyside and securities issuers, who are just learning about this significant change to market structure. This is no way to regulate our capital markets, which are the best in the world in part because of an organized, reliable, transparent, and predictable regulatory process.

As we will discuss in more depth in a future post, this application of the Rule may impede access to capital for some private companies that are not required to make Exchange Act filings (e.g., 144A issuers) and harm investors in their securities. The terms of the No-Action Letter fundamentally conflict with Rule 144A, which are offerings where information is specifically not required by SEC rules to be public.

There must be a formal and public rulemaking process

The industry shares the Commission's objectives to promote investor protection and promote transparency in the capital markets. However, we believe that applying this Rule to fixed income markets for the first time, without any opportunity for public input, on short notice, and outside of the normal regulatory process will negatively impact markets, issuers, investors and capital formation, and will actually lessen transparency and price discovery. For an issue of such importance, the SEC has a duty to follow a transparent rulemaking process that outlines the problem the SEC is trying to solve, provides an opportunity for public notice and comment, examines the costs of the proposed change against the benefits it would provide, and discusses alternatives to the proposed action, in accord with the Administrative Procedure Act. Instead, the SEC has operated in an opaque manner, which is the very opposite of its own goal to bring added transparency to the marketplace.

As the intermediary that brings together market participants, we welcome the opportunity to share how this surprising, unilateral interpretation is likely to negatively impact the ability of issuers to raise capital and investors to participate in the marketplace.

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[1] https://www.sec.gov/news/press-release/2020-212

[2] See Statement from Commissioner Hester Peirce, September 24, 2021: https://www.sec.gov/news/public-statement/peirce-nal-rule-15c2-11-2021-09-24

[3] https://www.sec.gov/files/fixed-income-rule-15c2-11-nal-finra-121621.pdf

[4] See https://www.sec.gov/files/fixed-income-rule-15c2-11-nal-finra-121621.pdf