SUPPORTING STATEMENT
For the Paperwork Reduction Act Information Collection Submission for
RULE 15g-4

A. Justification

(1) Necessity of Information Collection

The term "penny stock" generally refers to low-priced, speculative securities that are traded in the over-the-counter market. The great majority of securities that are eligible for trading in the United States are not traded on an established national securities exchange or the National Association of Securities Dealers Automated Quotation System ("NASDAQ"). Most of these non-NASDAQ, over-the-counter securities are not actively traded in any forum, and frequently there is little public information available with respect to their issuers.

Beginning in the mid-1980s, penny stock transactions and associated abuses grew geographically and in volume. Technological advances related to interstate telecommunications contributed substantially to this growth. This period also witnessed a dramatic growth in the number of broker-dealers that concentrated their activities primarily or entirely in penny stock transactions. In 1989, the Commission identified a corresponding increase in the number of investor complaints concerning these broker-dealers. Government officials and commentators have stressed the threat posed by penny stock fraud to economic progress and the legitimate securities industry. Penny stock fraud remains a serious national concern.

In its report concerning the Securities Enforcement Remedies and Penny Stock Enforcement Act of 1990 (the "Penny Stock Act"), the House Committee on Energy and Commerce (the "Committee") identified two primary factors spurring the growth of penny stock fraud: (i) a lack of public information concerning penny stocks, which facilitates price manipulation and deprives investors of a basis on which to make investment decisions, and (ii) the presence of a large number of individuals acting as promoters or associated with penny stock issuers or broker-dealers "who are repeat offenders of state or federal securities laws, other convicted felons, and persons having strong ties to organized crime."[1] With respect to recidivist offenders, the Committee noted the limited classes of persons that the Commission had authority to bar from association with broker-dealers.

Many of the abusive practices identified in the penny stock market can be attributed to the communication by broker-dealers to their customers of false or misleading information as to the value or market price of securities in order to induce transactions in those securities. These practices are more likely to flourish where there is a paucity of price, quotation, and other market information concerning a security. Where such information is available to investors, they have a

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1 House Committee on Energy and Commerce, Penny Stock Reform Act of 1990, H.R. Rep. No. 617, 101st Cong., 2d Sess. (July 23, 1990) (reporting H.R. 4497) ("House Report"), at 21.

greater ability to judge the veracity of sales agent claims. Most penny stocks are not actively traded in any secondary market, and dealer quotations, if they exist at all, traditionally have been confined to the "pink sheets." Moreover, pink sheet quotations generally do not serve as a reliable indication of the price at which a public customer could effect a purchase or sale transaction.

The large-scale and persistent pattern of abuse described above represents a continuing threat to individual investors in particular and to investor confidence generally. Moreover, issuers themselves may in some cases be deceived by promoters who make unfounded promises of easy and efficient access to new capital.

To help address these concerns, Rule 15g-4 was adopted by the Commission pursuant to the provisions of Section 15(g) of the Securities Exchange Act of 1934 (the "Exchange Act"). This section, which was added to the Exchange Act by Section 505 of the Penny Stock Act, mandates specific measures to increase the level of disclosure to investors concerning penny stocks generally and specific penny stock transactions.

Section 503 of the Penny Stock Act added Section 3(a)(51) to the Exchange Act, which generally defines the term "penny stock" to include equity securities other than securities that are traded on exchanges or automated quotation systems meeting criteria established by the Commission, issued by registered investment companies, or otherwise excluded or exempted by the Commission based on price, net tangible assets, or other relevant criteria. Section 3(a)(51) also grants to the Commission certain additional authority to classify or exempt securities as penny stocks. Rule 3a51-1 would further exclude from the term "penny stock" securities traded on an exchange or automated quotation system that meets certain requirements, transactions which are reported pursuant to a consolidated transaction reporting plan, or that are priced at five dollars per share or more.

Under Section 15(g)(1), it is unlawful for a broker or dealer to use the mails or other means of interstate commerce to effect, induce, or attempt to induce customer transactions in penny stocks except in accordance with the requirements of Section 15(g) and the rules promulgated thereunder. In general, Section 15(g): (i) requires broker-dealers, prior to effecting a penny stock transaction, to provide to the customer a risk disclosure document that contains certain information describing the nature and level of risk in the penny stock market, the broker-dealer's duties to the customer, and the customer's rights and remedies for violations, as well as a narrative description of certain aspects of a dealer market generally, all in such form and containing such additional information as the Commission may require by rule; (ii) mandates that the Commission adopt rules relating to the disclosure, prior to each penny stock transaction and in the customer confirmation, of information concerning (A) price data, including bid and ask quotations, and the depth and liquidity of the market for particular securities and (B) the amount and a description of the compensation received by broker-dealers and their associated persons; (iii) calls for Commission rulemaking to require broker-dealers to provide for customers monthly account statements indicating the market value of the penny stocks in their accounts or indicating that the market value cannot be determined because of the unavailability of firm quotes; and (iv) provides the Commission with authority to adopt additional rules regarding disclosure by broker-dealers to their customers of information related to penny stock transactions.

Rule 15g-4 makes it unlawful for a broker-dealer to effect a transaction in any penny stock without first disclosing, and subsequently confirming, to the customer the amount of compensation received by the broker-dealer in connection with the transaction.

The scope of the rule is limited by operation of Rule 3a51-1 and Rule 15g-1, which exempts certain transactions from certain rules adopted under Section 15(g). For example, the rule does not apply to transactions: (i) by a broker-dealer that does less than five percent of its securities business in penny stocks and that has not been a market maker, during the past year, in the penny stock that is the subject of the transaction; (ii) in securities the issuer of which has net tangible assets in excess of $2 million, if that issuer has been in continuous operation for at least three years, or $5 million, if the issuer has been in continuous operation for less than three years; (iii) where the purchaser is an institutional accredited investor; or (iv) that are not recommended by the broker-dealer. Other exclusions and exemptions are available.

(2) <u>Purpose and Use of the Information Collection</u>

The information is required to be provided to customers of broker-dealers that effect penny stock transactions in order to provide those customers with information that is not otherwise publicly available. Without this information, investors would be less able to protect themselves from fraud and to make informed investment decisions.

(3) <u>Consideration given to Information Technology</u>

The Commission's electronic filing project, called EDGAR for Electronic Data Gathering, Analysis & Retrieval, is designed to automate the filing, processing, and dissemination of full disclosure filings. Such automation will increase the speed, accuracy, and availability of information, generating benefits to investors and financial markets. This improved information technology is not applicable to this rule because the information is sent to individual investors and is meant to be contained in written form.

Broker-dealers that already provide account statements generally generate these statements through automated means through information systems that contain updated information concerning securities held in each customer's account. It is anticipated that broker-dealers furnishing account statements under the rule would also be able to generate account statements through automated means and that automated processing would limit the burden imposed by the requirement.

(4) <u>Duplication</u>

Broker-dealers are not otherwise required to provide the information required by the rule. Investors would have no assurance of receiving the information, or comparable information, in the absence of the rule.

(5) Effect on Small Entities

Some of the broker-dealers that are subject to the rule are small businesses. However, the additional cost of complying with the rule is minimal, because the information will already be known by or readily available to the broker-dealer. Broker-dealers are required to provide the information in writing following a trade, but because trade confirmations are already required, the additional burden relates to incorporating this information in the trade confirmations that are now provided.

(6) Consequences of Not Conducting Collection

The information generally is required to be disclosed, orally or in writing, prior to the trade, and is required to be disclosed in writing following the trade. Because in some cases, the information may not be readily obtainable prior to the transaction, the rule allows the information to be given promptly following the trade, provided that the customer is given the right to cancel the transaction after he or she receives the information. Because the central purposes of the rule are to provide investors with information needed to make investment decisions and to deter fraud in the penny stock market, it is essential that the information be provided prior to the time that the investor is bound to the trade. It is also essential that the information be provided in writing following the trade so that there is a written record for the benefit of the customer and to assure that the broker-dealer has complied with the rule. There is no comparable information already available to investors. The penny stocks covered by the rule are not traded in a market that makes such information publicly available. The information is available to broker-dealer firms but would not generally be provided to customers of those firms in the absence of the requirement imposed by the rule.

(7) Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)

There are no special circumstances. This collection is consistent with the guidelines in 5 CFR 1320.5(d)(2).

(8) Consultations Outside the Agency

The required Federal Register notice with a 60-day comment period soliciting comments on this collection of information was published. No public comments were received.

(9) Payment or Gift to Respondents

No payments or gifts are provided to any respondents.

(10) Confidentiality

Though the information is not now generally available to public investors, it is not considered confidential and no assurances of confidentiality are provided.

(11) Sensitive Questions

There are no questions of a sensitive nature asked. The information collection does not collect any Personally Identifiable Information (PII).

(12) Burden of Information Collection

The staff estimates that there presently are approximately 221 broker-dealers subject to the rule with respect to at least some of their transactions. The staff estimates that approximately 5% of registered broker-dealers are engaged in penny stock transactions, and thereby subject to the rule (5% x approximately 4,410 registered broker-dealers = 221 broker-dealers). The number of penny stock transactions conducted by each firm will vary widely, depending on the size of the firm and whether the firm concentrates its activities in penny stock transactions or conducts only a small portion of its business in this area. Broker-dealers that do less than five percent of their business in penny stocks will be exempt from the rule. A variety of types of transactions will be exempt, including transactions that are not recommended by the broker-dealer. The staff estimates that, on average, each firm subject to the rule will effect approximately 5,225 total transactions that would be subject to the rule annually and that the average third-party disclosure burden of adding the information to trade confirmations would be one minute per transaction. Accordingly, the estimated average annual burden per firm would be 87 hours (5,225/60 = 87.08), and the estimated average annual total burden on all firms would be 19,245 hours (87.08 x 221).

(13) Costs to Respondents

There are no capital, start-up or other external costs on respondents associated with the rule.

(14) Costs to Federal Government

There are no costs to the federal government associated with these rules.

(15) Changes in Burden

The total annual hourly burden of compliance has increased from approximately 18,200 to 19,246 hours due to a change in methodology for estimating the number of broker-dealers affected. Since the identities of penny stock dealers are not readily available, the staff of the Commission developed a methodology to identify them. The change was made in order to be consistent in methodology among the various penny stock rules. We previously estimated that 209 broker-dealers were subject to the penny stock rules. We now estimate that there are approximately 221 broker-dealers subject to the penny stock rules.

(16) Information Collection Planned for Statistical Purposes

Not applicable because the information will not be used for statistical purposes.

(17) Approval to Omit OMB Expiration Date

The Commission is not seeking approval to omit the expiration date.

(18) Exceptions to Certification for Paperwork Reduction Act Submissions

This collection complies with the requirements in 5 CFR 1320.9.

B. Collection of Information Employing Statistical Methods

This collection does not include statistical methods.