

Commentary: A Gap in Regulation of the OTC Markets

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On December 17, 2009, the SEC released a proposal by FINRA to clarify FINRA's authority to process corporate actions by issuers with securities traded in the over the counter (OTC) markets. As rule changes go, this one is fairly obscure. It is therefore strange how many calls I have received from clients who are outraged about this proposal.

Maybe this is one more sign of the times we are living in. Everyone seems to be angry about something.

FINRA, as has been pointed out by the courts on any number of occasions, is the primary regulator of the OTC markets. It can be argued that this was the reason it was instituted in the first place. The fact is that FINRA exists to correct a Congressional oversight.

Congress created the Securities Exchange Act of 1934 to regulate the securities markets, which to the Congress of 1934 meant the Exchanges, and most especially The New York Stock Exchange. That is why it was called the "Exchange Act," rather than the "Securities Markets Act" or some other more expansive title. The idea was that stock exchanges operating in the United States would become self-regulatory organizations of their members, as well as the markets represented by the exchanges. Among other things, this meant that the industry would pay for its own regulation, a theory of regulatory taxation that remains a recurring theme in 2010.

This theory of regulation, however, left to one side the vast OTC markets. In 1934, the OTC markets included most corporate and government bonds and all the securities derivatives markets. Many of the brokers and dealers who worked in these markets were not members of any exchange, and therefore not subject to self-regulatory organization, something Congress discovered to its horror when the Puts and Calls Association of New York showed up a few years later to lobby on behalf of the options markets.

To correct this oversight, Congress created Section 15A of the Exchange Act in 1938, which instituted something called a "national securities association." The National Association of Securities Dealers, Inc. (NASD), FINRA's predecessor, was

established in 1939. The NASD was the only one of its kind until the National Futures Association (NFA) was created sixty years later.

FINRA regulates the OTC markets by supervising the conduct of its broker-dealer members, and indirectly, the customers of broker-dealers. This regulation is memorialized in FINRA's Rules of Fair Practice, and more importantly perhaps, through the Uniform Practice Code (UPC). The UPC, while little known outside the back office, regulates clearance and settlement of trades in OTC securities, as well as dividend and interest payments, including who is entitled to receive them.

Unfortunately, this regulatory design contains a flaw that raises its ugly head from time to time.

Securities cannot be traded on a national securities exchange unless their issuer has entered into a listing agreement with the stock exchange. Listing agreements enables an exchange to regulate the conduct of the issuers whose securities are traded there, which means that the stock exchange is also the self-regulator of its listed issuers. As is the case of the broker-dealer members of an exchange, the issuer of listed securities pays for the cost of its own regulation by the exchange.

In contrast, issuers of OTC securities are not regulated by FINRA. Since FINRA does not have any contractual relationship with any issuer, and Congress has not granted it the authority to regulate issuers, FINRA lacks any ability to discipline miscreant issuers.

Despite this lack of regulatory authority, Rule 10b-17 under the Exchange Act requires OTC issuers to notify FINRA ten days prior to the record date for a dividend, stock split or rights offering. Failure to give the requisite notice constitutes a "manipulative or deceptive device or contrivance." The newly-proposed FINRA rule would require an OTC issuer to pay \$200 to FINRA as a processing fee for these notices, an amount that would rise to \$2,000 or more if an issuer is late in its reporting obligations.

So, what happens if an OTC issuer fails to provide the requisite 10b-17 notice, or refuses to pay the required processing fee? FINRA's rules are not binding on OTC issuers, who are not members of FINRA. So, the only remedy for FINRA is to refuse to process the action, which is what the proposed rule purports to clarify. But, that is not a particularly satisfying result.

A 10b-17 notice, after all, alerts the markets to a dividend payment. If FINRA refuses to process the notice, market participants may be unaware that a dividend will be paid, or worse yet, some participants will know, while others do not, providing opportunities to trade on the basis on non-public information. It is,

therefore, more important to the markets than it is to the issuer for FINRA to process corporate actions.

It gets worse. Among other things, FINRA uses a dividend notice to set an “ex-dividend date,” which is the trading day on which the purchaser will no longer receive the dividend. A few months ago, Inter-American Acquisition Group Inc. (IAQG), an OTC issuer, disliked the ex-date set by FINRA. So, it decided to send dividend payments directly to its own list of beneficial owners. As a result, investors who purchased after the record date, but before the ex-dividend date, with the legitimate expectation of receiving the dividend, have not been paid. This is a big mess, and so far there is no indication that FINRA has any plan to try to straighten it out. Sadly, this sort of thing is happening with greater frequency.

Investors should be able to purchase securities in the OTC markets with the assurance that they will receive what they paid for. Investors that purchase securities prior to an ex-dividend date with the legitimate expectation of receiving a dividend under FINRA’s market rules should not have to worry that the dividends they paid for will be delivered to someone else when an issuer thumbs its nose at FINRA.

Rule 10b-17 was promulgated under the SEC’s authority to make rules to prevent manipulative and deceptive practices under Section 10(b) of the Exchange Act. It belongs to the same series of rules as the much-feared Rule 10b-5, which prohibits trading on the basis of non-public information and other fraudulent and deceptive practices. Since FINRA lacks the authority to enforce Rule 10b-17 against issuers, it is up to the SEC to do something when an issuer decides to ignore its obligations.

Regrettably, my research has not found a single enforcement action brought by the SEC against an issuer for violating Rule 10b-17. I am also not aware of any procedures within FINRA for bringing to the SEC’s attention violations of Rule 10b-17. This gap in regulatory enforcement tends to render compliance voluntary, one of those things an OTC issuer will do only if it is so inclined.

This regulatory gap is unfortunate because the OTC markets are so important to our nation’s economy. They are the wetlands where small enterprises led by energetic entrepreneurs try to create the next Apple or Microsoft. Investors in OTC securities that are willing to incur the inevitable risk that interesting new ideas will fail, rendering their investment worthless, should not also be forced to worry that they will not receive dividends to which they are entitled.

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